

Treasury and IRS Issue Eagerly-Awaited Guidance on Hardship Distributions – with a Few Surprises

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Last Friday, the IRS issued eagerly-awaited proposed regulations regarding hardship distributions under section 401(k) and 403(b) plans (the “Proposed Regulations”). The Proposed Regulations primarily address hardship distribution issues raised by the Bipartisan Budget Act of 2018 (the “Budget Act”). (For our earlier blog entry summarizing these issues, click [here](#).) At the same time, the Proposed Regulations address related hardship distribution issues implicated by the 2018 Tax Cuts and Jobs Act (the “Tax Act”) and recent disaster relief guidance. Plan sponsors should review the Proposed Regulations carefully. Even before the Proposed Regulations are finalized, plan sponsors will need to consider administrative and plan amendment changes to conform to the new rules.

As a general rule, there are two key components for a permissible hardship distribution: (1) the withdrawal must be made due to an immediate and heavy financial need; and (2) the amount of the withdrawal must be limited to the amount necessary to satisfy that financial need. Existing regulations provide detailed rules for how plan participants can prove each requirement is met when requesting a withdrawal. The Proposed Regulations would modify and relax many of these rules to conform to new law changes.

Elimination of Six-Month Contribution Suspension Requirement

Under current “safe harbor” hardship distribution regulations, participants who take a hardship distribution are prohibited from making future contributions to the plan and other employer-sponsored plans for six months. Congress determined that this rule prevents participants from replenishing their accounts after a hardship distribution and directed the IRS to issue regulations to fix the problem. As directed by the Budget Act, the Proposed Regulations eliminate the six-month contribution suspension requirement.

The elimination has an interesting effective date. It may be applied on the first day of the first plan year beginning after December 31, 2018 (January 1, 2019 for a calendar year plan) even if the distribution was made in the prior plan year. For example, assume a calendar-year plan provides for hardship distributions under the pre-2019 safe harbor standards and a participant took a hardship distribution in the second half of the 2018 plan year. The plan may be amended either to end the suspension period for contributions as of January 1, 2019 or to continue the suspension for the originally-scheduled six months.

Separately, the Proposed Regulations indicate that for *distributions made* on or after January 1, 2020 (regardless of the plan year), a 401(k) plan may not provide for a suspension of contributions as a condition to obtaining the distribution. In other words, after 2019 the suspension period is not available even as an optional design matter.

Practice Point on 409A Implications: Plan sponsors should consider the potential impact of this new rule on their nonqualified deferred compensation plans subject to Code Section 409A. Under the Section 409A regulations a nonqualified deferred compensation plan is allowed to cancel a participant's nonqualified plan deferral election if a participant takes a 401(k) hardship distribution. This Section 409A rule was intended to allow nonqualified deferred compensation plans to conform to the six-month suspension rule. Depending on when a plan sponsor eliminates the 401(k) suspension period, there could be related consequences for administration of the nonqualified deferred compensation plan.

No Need to Take Available Plans Loans Before a Hardship Distribution

Another existing safe harbor rule to demonstrate that a requested hardship distribution is necessary is that the participant must take all plan loans otherwise available before taking the hardship distribution. Consistent with the Budget Act, the Proposed Regulations would remove this requirement effective for hardship distributions made in plan years beginning after December 31, 2018. Unlike the elimination of the six-month suspension period, however, the elimination of this requirement is not mandatory. Plans could continue to impose a requirement that participants take plan loans before being eligible for a hardship distribution.

New Circumstances for Hardship Distributions

Under current IRS hardship distribution safe harbor regulations, an employee is considered to have an immediate and heavy financial need if the need falls into one of six categories of hardship events. The Proposed Regulations modify the permitted safe harbor events in several ways that participants and plan administrators will likely find helpful:

- Before the Tax Act, a participant could take a hardship distribution for expenses to repair damage to the participant's principal residence if the damage qualified for a casualty loss deduction under Code Section 165. Through 2025, the Tax Act eliminated the casualty loss deduction unless the loss was due to a federally-declared disaster. In what many believed to be an unintended consequence, this change resulted in many participants being ineligible to take a hardship distribution if their homes were damaged for reasons other than federally-declared disasters. The Proposed Regulations would restore the casualty loss hardship distribution event to the pre-Tax Act standard.
- Hardship distributions for qualifying medical, educational, and funeral expenses include those expenses incurred by a participant's "primary beneficiary" (someone named as a beneficiary and who has an unconditional right, upon the employee's death, to all or part of the employee's plan account). This modification incorporates the prior guidance issued by the IRS in Notice 2007-7 that permitted plans to allow hardship distributions for medical, tuition, and funeral expenses incurred on behalf of a primary beneficiary.
- Under a new category of permitted hardship distribution events, participants could take a hardship distribution due to expenses and losses (including loss of income) incurred after federally-declared disasters (as long as the participant's home or principal place of business at the time of the disaster was located in an area designated for federal assistance). This change would allow many plans to offer immediate assistance to affected participants without having to wait for the IRS or Congress to take specific action in response to the disaster.

These changes generally apply for distributions made in post-2018 plan years; however, they may be applied to hardship distributions made on or after a date as early as January 1, 2018. This allows plan sponsors to conform their plans retroactively to actual operational activity. For example, if a plan continued to allow for casualty loss hardship distributions without regard to the changes imposed by the Tax Act, it could be retroactively amended to conform to the new Proposed Regulation rule.

Expansion of Sources for Hardship Distributions

Consistent with the Budget Act, the Proposed Regulations expand the sources available for hardship distributions to include earnings on elective deferrals, QNECs, QMACs, and earnings on QNECs and QMACs. The preamble to the Proposed Regulations also confirms that safe harbor 401(k) employer contributions (and earnings thereon) are also available sources for hardship distribution.

Plan sponsors would not be required to expand the available sources for hardship distributions. Instead, they could continue to limit the amounts available for hardship distributions consistent with the prior rules. However, plan sponsors should coordinate with their recordkeepers to make sure their design decisions will be implemented properly.

Special Consideration for 403(b) Plans: Under the Proposed Regulations, earnings on pre-tax deferrals made to a 403(b) plan continue to be ineligible for hardship distributions. However, QNECs and QMACs would be eligible for hardship distributions in a section 403(b) plan that is not in a custodial account. QNECs and QMACs in a section 403(b) plan that is held in a custodial account would continue to be ineligible for hardship distributions.

Plan Administrators May Rely Solely on New Participant Representation

The Proposed Regulations would eliminate the current rule that the determination of whether a distribution is necessary to satisfy a financial need is based on all the participant's relevant facts and circumstances. Instead, for hardship distributions made on and after January 1, 2020, a participant must represent (in writing or *by electronic means*) that the participant has insufficient cash or liquid assets to satisfy the financial need. A plan administrator could rely on the representation in the absence of actual knowledge to the contrary.

Applicability Date and Deadline to Amend Plans

The Proposed Regulations generally apply to hardship distributions made in plan years starting after December 31, 2018, unless an exception otherwise applies (for example, the revised list of safe harbor expenses may be applied to distributions made on or after January 1, 2018 and the elimination of the six-month suspension could be applied to suspension periods in place as of the beginning of the 2019 plan year).

Special Note - Plan Amendment Required: Plans that permit hardship distributions will need to be amended to reflect these new hardship distribution rules once the regulations are finalized. These amendments would be treated as qualification requirement amendments and subject to an extended due date for plan amendments. The final date is to be determined; however, the general rule is that plans have until the end of the second calendar year beginning after the issuance of an IRS-issued “Required Amendments List” reflecting the new rules. That is the outside date for amendments, however. Plan sponsors should consider plan amendments well in advance of any final deadline.

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