MERCER
MAKE TOMORROW, TODAY

LAW & POLICY GROUP

GRIST

IRS FINALIZES HARDSHIP DISTRIBUTION RULES

By Mercer's Brian Kearney and Margaret Berger
Sept. 25, 2019

In This Article
Existing Hardship Rules | Final Rules | Applicability Dates | Related Resources

Recently issued IRS final regulations updating the hardship distribution rules for 401(k) and 403(b) defined contribution (DC) plans are "substantially similar" to the 2018 proposal, with only a few minor clarifying changes. However, the preamble gives some helpful answers to questions IRS received in comments on the proposed rules. The final rules generally are effective for distributions on or after Jan. 1, 2020, but sponsors have options for applying the rules sooner.

EXISTING HARDSHIP RULES

Under existing regulations for Internal Revenue Code Section 401(k), plans can make hardship distributions if two conditions are met:

- A participant has an "immediate and heavy financial need."
- The distribution is necessary to satisfy the need.

A distribution is not considered necessary to satisfy an immediate and heavy financial need to the extent the employee has other resources (including assets of the employee's spouse and minor children) reasonably available to relieve that need. Unless the employer has actual knowledge to the contrary, it may rely on the employee's representations that no other resources are available to meet the need.

Employers must make hardship determinations by reviewing all relevant facts and circumstances and applying nondiscriminatory and objective standards set forth in the plan. However, to simplify administration, the regulations include certain safe harbors that employers may use to decide whether a distribution satisfies these requirements.

Expense safe harbors. The regulations deem distributions for certain types of safe harbor expenses (the "expense safe harbors") to be on account of an immediate and heavy financial need. Plans can use the

MARSH & McLENNAN COMPANIES

facts-and-circumstances test, the expense safe harbors, or both for handling hardship distribution requests.

Necessity safe harbor. Another safe harbor deems a distribution necessary to satisfy the financial need if the employee both:

- Takes all available distributions, including nontaxable loans, from all of the employer's qualified and nonqualified plans.
- Is prohibited from making contributions to all of the employer's plans for six months after the distribution.

FINAL RULES

The final rules are almost identical to the proposal, with just a few changes as noted below. (For a detailed explanation of the proposed rules, see IRS Proposes Updates to Hardship Withdrawal Rules, Nov. 27, 2018.)

Changes to Expense Safe Harbors

The new rules make the following changes to the expense safe harbors:

- Extend the expense safe harbors for certain medical, education and funeral expenses to an employee's "primary beneficiary under the plan" — not just employees, their spouses, parents, children and dependents, as under the current expense safe harbors.
- Modify another safe harbor — costs to repair an employee's principal residence that would qualify for the casualty deduction under Section 165 (ignoring its limits on adjusted gross income) — to disregard recent tax law changes limiting that deduction to losses incurred in 2018–2025 as a result of a federally declared disaster.
- Add a new safe harbor for losses (including noncasualty losses, such as an employee's loss of income) incurred by an employee in a federally declared disaster zone where the employee's principal residence or principal place of employment is located.

The final rules adopt these changes without modifying the proposal.

More information on new expense safe harbor. In the preamble to the final rules, IRS says the new safe harbor should eliminate the need to issue ad hoc relief for specific disasters. Past grants of disaster relief typically relaxed the procedural requirements for hardship distributions and loans and allowed plans that didn't already provide for those distributions to make them to affected employees, as long as the plans were later amended by a deadline set in the announcement.

IRS also points out three key differences between the new expense safe harbor and prior disaster relief:

- The safe harbor only covers employees who lived or worked in the disaster area. Expenses and losses of the employee's relatives and dependents are ineligible.

- The new rules set no specific deadline for requesting a disaster-related hardship distribution and contain no specific authority for relaxing the plan's procedural requirements for hardship distributions. However, IRS expects administrators will be flexible with plan procedures when processing hardship distribution requests after a disaster.

- No special or extended deadline applies for adding disaster-related distribution provisions to a plan. A sponsor may add the new expense safe harbor as part of an amendment reflecting the final rules or at any time thereafter. If a sponsor waits until a later date, the amendment must be adopted by the end of the plan year the new provisions take effect. However, IRS may issue additional guidance to address delayed amendment deadlines when sponsors add the new expense safe harbor to their plans in response to a particular disaster.

Distribution Necessary To Satisfy Financial Need

The new rules replace both the facts-and-circumstances test and the necessity safe harbor with one general standard for determining whether a distribution is necessary. The new standard incorporates aspects of both the old facts-and-circumstances test and the necessity safe harbor:

- A hardship distribution may not exceed the amount of an employee's need (including any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

- The employee must obtain all distributions available for reasons other than hardship under the employer's plans — excluding plan loans (as required under the old necessity safe harbor).

- The employee must make a representation about having insufficient cash or other liquid assets to satisfy the financial need. Absent actual knowledge to the contrary, the plan administrator can rely on this representation.

Suspensions no longer allowed. The Bipartisan Budget Act of 2018 (BBA) (PL 115-123) directed Treasury to amend the 401(k) regulations for plan years starting after Dec. 31, 2018, to eliminate the necessity safe harbor's requirement to suspend an employee's elective deferrals and other employee contributions for six months after a hardship distribution. The new rules make this change, but (like the proposed rules) go even further by prohibiting suspensions effective for all hardship distributions made on or after Jan. 1, 2020.

The proposed rule didn't specify whether the prohibition on suspensions applies to all of the employer's plans. However, the final rule makes clear that the prohibition applies to qualified plans, 403(a) and 403(b) plans, and 457(b) plans maintained by governmental employers, but not nonqualified plans. Employers can keep suspension provisions in a nonqualified plan (or eliminate them to the extent consistent with Section 409A).

The preamble also confirms that the prohibition on suspensions applies to matched employee contributions. (Some earlier IRS revenue rulings said plans must place a substantial limitation, such as a suspension of contributions, on an employee's right to withdraw matched employee contributions.)

Plan loans. Unlike the old necessity safe harbor, the new general standard does not require participants to take out all nontaxable plan loans under all of the employer's plans. However, plans may require employees to exhaust plan loans before taking a hardship distribution.

Other conditions on hardship distributions. The preamble confirms that plans may place other conditions on hardship distributions, for example:

- Limiting hardship distributions to expenses not reimbursable by insurance
- Requiring liquidation of assets available to the employee, spouse and minor children
- Mandating exhaustion of other available distributions from plans maintained by the employer or another employer
- Having an application process
- Requesting supporting documentation
- Imposing a nondiscriminatory, minimum dollar amount for a hardship distribution
- Requiring employees first to borrow from commercial sources on reasonable commercial terms

Availability of cash and liquid assets. One revision to the final rules makes clear the representation that an employee has insufficient assets to meet the financial need reflects only cash or other liquid assets "reasonably available" to the employee. For instance, an employee with cash or other liquid assets on hand can still satisfy this requirement if those assets are earmarked for other obligations (such as rent).

Representations via electronic medium. IRS tweaked the final rule to clarify that an employee can make the required representation via any electronic medium that's permissible for participant notices and elections (such as telephone, email or websites).

No requirement to inquire about employees' finances. Plan administrators don't have to inquire into the financial condition of employees who ask for hardship distributions. The "actual knowledge" condition is limited to situations when the administrator already has sufficiently accurate information about the employee to determine whether the representation is true.

Expanded Sources of Hardship Distributions (QNECs and QMACs)

Hardship distributions can now be made from elective contributions, qualified nonelective contributions (QNECs), qualified matching contributions (QMACs) and earnings on these amounts. The preamble confirms that this includes QNECs and QMACs in safe harbor plans — both traditional safe harbor plans and qualified automatic contribution arrangements (QACAs). A plan may limit the types of contributions available for hardship distributions — plans that don't already offer distributions from all these sources needn't be amended to do so.

Other Issues

The preamble also clarifies the following:

- A plan relying on the expense safe harbors doesn't have to recognize all safe harbor expenses or all categories of individuals with medical, education and funeral expenses permitted under the hardship distribution rules.
- When updating safe harbor plans midyear to reflect the final rules, sponsors can follow the notice-timing and election-opportunity requirements for midyear amendments in Notice 2016-16.

Section 403(b) Plans

Although the final rules generally apply to hardship distributions from 403(b) plans, the preamble clarifies and confirms several issues for those plans:

- The required representation about the employee's cash and liquidity will not violate 403(b)'s prohibition against employees self-certifying their eligibility for hardship distributions (or loans).
- Income attributable to 403(b) elective deferrals remains ineligible for distribution on account of hardship. This is because BBA amended Section 401(k) — but not 403(b) — to allow hardship distributions from earnings on elective deferrals.
- QNECs and QMACs in a 403(b) custodial account are ineligible for hardship distributions (because under the 403(b) regulations, hardship is not a distributable event for amounts in custodial accounts other than elective deferrals). However, QNECs and QMACs not held in a custodial account are available for hardship distributions.
- The prohibition on suspensions after a hardship distribution applies to 403(b) plans, including preapproved 403(b) plans. Earlier IRS guidance on preapproved 403(b) plans had required suspending elective deferrals for six months after a hardship distribution.

APPLICABILITY DATES

The final rules are effective for hardship distributions made on or after Jan. 1, 2020 — rather than plan years beginning after Dec. 31, 2018, as stated in the proposed rules. However, employers can choose to apply the final rules for distributions made in 2019. Employers that decide not to apply the new rules this year must follow the existing regulations on hardship distributions until 2020, but can implement any statutory changes already in effect (such as elimination of the necessity safe harbor's suspension requirement).

Employers that apply the new rules before 2020 should note the following:

- Plans may not suspend elective deferrals and employee contributions for distributions made after 2019, but may halt suspensions as early as the first day of the first plan year beginning after Dec. 31, 2018. This is true even if the distribution took place in the prior plan year. For example, a plan with an Oct. 1–Sept. 30 plan year that provides for hardship distributions under the prior safe harbor standards can cut off suspensions as of Oct. 1, 2019 (or let them run their course).

- For distributions made before 2020, employers can disregard the new requirements for employee representations.

- Employers may use the revised list of safe harbor expenses for distributions made on or after Jan. 1, 2018. For example, a plan that made hardship distributions in 2018 without regard to the recent change limiting casualty-loss deductions can adopt a conforming amendment to reflect the plan's operation. This amendment will be due at the same time a plan must otherwise be amended for the final rules (see "Plan Amendments" below).

Plan Amendments

IRS expects that sponsors will need to amend their plans to reflect the final regulations. The amendments must be effective for distributions beginning no later than Jan. 1, 2020, and adopted by the deadline for amending disqualifying provisions under Rev. Proc. 2016-37. For purposes of the hardship rules, this deadline applies to both required amendments to correct disqualifying provisions (e.g., amendments eliminating suspension provisions) and amendments that aren't required but are integrally related to changes in the qualification requirements (e.g., amendments reflecting the change to the expense safe harbor for deductible casualty losses and the new expense safe harbor for federally declared disasters).

Individually designed plans. For an individually designed plan that is not a governmental plan, the amendment deadline is the end of the second calendar year that begins after IRS issues the Required Amendments (RA) List that includes the change. If the final regulations are included in the 2019 RA List, the deadline will be Dec. 31, 2021 (regardless of the plan year).

Preapproved plans. For preapproved plans, the amendment timing under Rev. Proc. 2016-37 varies depending on several factors, including the type of entity sponsoring the plan and the plan year. For example, if an employer with a calendar-year tax year maintains a calendar-year preapproved plan, the amendment deadline is the tax-filing deadline (plus extensions) for the year in which the plan change takes effect. So, for this employer, the interim amendment deadline for all changes related to the final hardship rules is the employer's tax-filing deadline (plus extensions) for 2020.

403(b) plans. Several commenters asked for guidance on the amendment deadlines for 403(b) plans (both preapproved and individually designed). Under Rev. Proc. 2017-18, the remedial amendment deadline for

403(b) plan sponsors to adopt plan documents is March 31, 2020. Treasury and IRS may provide a later amendment deadline for amendments relating to the final hardship rules in separate guidance.

RELATED RESOURCES

Non-Mercer Resources

- Final IRS Regulations on Hardship Distributions (Federal Register, Sept. 23, 2019)
- Retirement Topics — Hardship Distributions (IRS, June 18, 2019)
- Rev. Proc. 2017-18 (IRS, Jan. 13, 2017)
- Rev. Proc. 2016-37 (IRS, June 29, 2016)

Mercer Law & Policy Resources

- IRS Proposes Updates to Hardship Withdrawal Rules (Nov. 27, 2018)

Note: Mercer is not engaged in the practice of law, accounting or medicine. Any commentary in this article does not constitute and is not a substitute for legal, tax or medical advice. Readers of this article should consult a legal, tax or medical expert for advice on those matters.