IRS snapshot reflects updated 401(k) hardship distribution rules

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A new IRS issue snapshot examines the rules for hardship distributions from 401(k) plans after changes made by the Bipartisan Budget Act of 2018 (BBA 2018) (Pub. L. No. 115-123) and a 2019 final regulation. Although the snapshot doesn't offer any new guidance, IRS has provided a useful, streamlined summary of the hardship distribution requirements. Snapshots also serve as training materials for IRS auditors and typically highlight compliance issues IRS will review during an audit.

Hardship distribution overview

Plans can make hardship distributions if a participant has an "immediate and heavy financial need" and the distribution is limited to the amount necessary to satisfy the need. The 401(k) regulations list certain safe harbor expenses deemed to indicate an immediate and heavy financial need, although other expenses may qualify under a facts-and-circumstances test. The regulations also identify certain conditions that must be satisfied to show the distribution doesn't exceed the participant's need.

The snapshot explains the rules for hardship distributions of elective deferrals, qualified matching contributions (QMACs), qualified nonelective contributions (QNECs) and earnings on those contributions under 401(k) plans. The rules also generally apply to 403(b) plans, except hardship distributions cannot be made from earnings on elective deferrals or from QMACs and QNECs — including earning on those amounts — held in 403(b) custodial accounts (Congress is currently considering legislation that would lift these restrictions). The snapshot also notes that more lenient rules apply to hardship distributions of profit-sharing 401(k) contributions, although many plans apply the more stringent criteria to these hardship distributions to ease the administrative burden.

Recent changes to hardship distribution rules

The snapshot reflects recent changes to the hardship distribution rules made by BBA 2018 and the 2019 regulation. These changes include:

- New safe harbor expenses deemed to be an immediate and heavy financial need
- One standard for determining that the distribution is limited to the participant's need

- Prohibition on requiring suspension of elective deferrals after a hardship distributions
- Exclusion of nontaxable loans from the requirement that participants take all available distributions before a hardship distribution
- Requirement that participants represent they can't satisfy their financial need from other resources
- Expanded sources of hardship distributions from 401(k) plans, including QNECs and QMACs with earnings, as well as earnings on employee elective contributions

Audit tips

The snapshot notes that IRS agents will review documentation during an audit to confirm that a distribution met the immediate and heavy need criteria and was properly limited in amount. Relevant documentation might include items like medical and tuition bills, eviction notices, or closing documents for purchase of a principal residence, and documentation attesting that the employee has insufficient cash or other liquid assets reasonably available to relieve the hardship. IRS auditors will also examine forms and statements provided by employees for proper signatures — especially for spousal consent, if applicable — and will look for proper reporting of the distributions on Form 1099-R.

Related resources

Non-Mercer resources

- Hardship distributions from 401(k) plans (IRS, June 23, 2021)
- Final rule, Hardship distributions of elective contributions, QMACs, QNECs, and earnings (Federal Register, Sept. 23, 2019)
- Pub. L. No. 115-123, Bipartisan Budget Act of 2018 (Congress, Feb. 9, 2018)

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- IRS finalizes hardship distribution rules (Sept. 25, 2019)

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