BLOG

Proposed IRS Regulations Make Additional Changes to Hardship Withdrawal Rules for 401(k) and 403(b) Plans

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The IRS recently released proposed amendments to the hardship distribution regulations for 401(k) (and, by extension, 403(b)) plans, which take into account recent statutory changes and add some additional nuances. Highlights of the changes include:

- **Expanded safe harbor hardship reasons**. The rules provide that a distribution is deemed to be on account of an immediate and heavy financial need where expenses and losses are incurred as a result of FEMA-declared disasters, provided that the participant's principal residence or principal place of employment at the time of the disaster was located in the disaster area. This is a welcome change, as it would eliminate the need for a plan sponsor to adopt separate plan amendments updating hardship withdrawal reasons for each new FEMA-declared disaster.
- **Changed rules for determining whether a distribution is necessary to satisfy an immediate and heavy financial need**. These rules:
- Eliminate the "all relevant facts and circumstances" test, thus permitting only deemed safe harbor evidence that a distribution does not exceed the participant's financial need.
- Require the employee to have obtained any other available distributions under all plans of deferred compensation maintained by the employer, whether qualified or nonqualified.
- Require, effective for distributions made after January 1, 2020, that the employee represent in written or electronic form that he or she has insufficient cash or liquid assets to satisfy the financial need; a plan administrator may rely on this representation unless it has actual knowledge to the contrary. Previously, this "self-certification" by the employee was an optional method for confirming that other resources were not available to the employee, and the certification required employees to confirm that a broader range of resources were not available to them (e.g., commercially available loans).
- **Six-month suspension of deferrals is eliminated**. Plans may eliminate the six-month post-hardship suspension of deferrals for plan years after December 31, 2018, and **must** eliminate this deferral suspension for distributions made on or after January 1, 2020.

- **Expanded sources for hardship distributions**. The new rules expand the sources of permissible hardship distributions (effective as early as January 1, 2018) to include earnings on elective deferrals, QNECs (and earnings thereon), and QMACs (and earnings thereon), or any combination thereof. However, plan sponsors may still limit the sources of contributions available for hardship distributions if they choose to do so.
- **Plan loan requirement is eliminated**. Effective for plan years beginning after December 31, 2018, plans need not require participants to take available plan loans (or show that the loans would not relieve the hardship) before taking a hardship withdrawal. Unlike the six-month suspension of deferrals, the elimination of the plan loan requirement is not mandatory.
- **Beneficiary's expenses are included**. The proposed regulations incorporate the rules published under Section 826 of the Pension Protection Act of 2006 that add the participant's primary beneficiary under the plan as an individual with respect to whom the participant may incur qualifying medical, education, and funeral expenses.
- **Clarify pre-2017 tax reform rules for casualty losses**. The proposed regulations clarify that damage to a principal residence is considered a safe harbor expense qualifying a participant to take a hardship withdrawal, without regard to the Tax Cut and Jobs Act of 2017 change to Code Section 165 that limited the deduction for personal casualty loss to losses attributable to federally declared disasters for tax years 2018 through 2025. This rule may be applied as early as January 1, 2018.
- **Safe harbor plans**. The proposed regulations specifically provide that safe harbor plans are not required to eliminate the post-hardship suspension of deferrals until January 1, 2020, the same date the rule applies to all plans. However, the proposed regulations do not expressly permit plan sponsors to rely on the regulations prior to their final approval, and under the Bipartisan Budget Act of 2018, safe harbors plans are seemingly required to eliminate such suspension effective January 1, 2019.
- **403(b) plans**. The changes to the hardship withdrawal rules described above also generally apply to Section 403(b) plans, with two exceptions. First, the proposed regulations do not eliminate the restriction under Section 403(b) that prohibits distribution of earnings attributable to elective deferrals in a 403(b) plan on account of hardship. Second, QNECs and QMACs that are in a custodial account in a Section 403(b) plan cannot be distributed on account of hardship.

Many plan sponsors and third-party service providers had already taken steps to adopt some or all of these changes, based on the legislative changes to the hardship withdrawal rules promulgated in the Bipartisan Budget Act of 2018 and the Tax Cuts and Jobs Act of 2017. Plan sponsors should discuss these new proposed regulations with ERISA counsel to determine which provisions may be applicable to their plans, and when their plans should be amended to reflect the new rules.

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