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New Rules Regarding Hardship Distributions

Recently, the IRS issued proposed regulations that would change certain rules pertaining to hardship distributions. These regulations are still in proposed form, and the IRS is seeking comments. However, we believe plan sponsors should consider the application of the new rules.

Background

Generally, elective deferrals made to a 401(k) plan cannot be distributed prior to an active participant reaching age 59-1/2. One exception is a hardship distribution, which is permissible due to an immediate and heavy financial need, to the extent necessary to satisfy that financial need.

A. *Application to 401(k) Plans*

1.) Elimination of Six Month Contribution Suspension

- The proposed regulations eliminate the safe harbor requirement that a participant who takes a hardship distribution must be suspended from making future contributions for six months. Moreover, as discussed below, effective for the 2020 plan year, a suspension is no longer permitted.

- Consideration should be given to how the elimination of the six-month suspension could affect elective deferrals under a nonqualified deferred compensation plan.

2.) Qualifying for Hardship

- The proposed regulations eliminate the existing safe harbor requirement that a participant must take all plan loans available to him or her before taking a hardship distribution. However, it is permissible to continue to require that participants take plan loans before they may receive hardship distributions.

- The proposed regulations eliminate the current facts-and-circumstances test to determine if a hardship distribution is necessary to satisfy an immediate and heavy financial need. Instead, the participant must take all available plan distributions and provide a written or electronic representation that he or she has insufficient cash or liquid assets to satisfy the relevant financial need. The plan administrator may rely on the representation if it does not have actual knowledge to the contrary.

3.) New Sources for Hardship Distributions

- The proposed regulations expand the sources available for hardship distributions to include Qualified Nonelective Contributions ("QNECs"), Qualified Matching Contributions ("QMACs"), and the investment earnings attributable to elective deferrals, QNECs and QMACs.

4.) Hardship Circumstances

- The proposed regulations expand the safe harbor list of circumstances for which a hardship withdrawal may be made to include expenses incurred as a result of certain federally declared disasters.

- In accordance with a change made under prior law, medical, educational, or funeral expenses of the primary beneficiary of a participant are now included in the safe harbor list of circumstances for which a hardship withdrawal is permitted.

B. *403(b) Plan Rules*

The proposed regulations also apply, for the most part, to 403(b) plans. However, earnings attributable to elective deferrals cannot be part of a hardship distribution under a 403(b) plan, and QNECs and QMACs are eligible for hardship distributions under a 403(b) plan only if held under an annuity contract rather than in a custodial account.

C. *Effective Dates*

Generally, the proposed regulations are effective for plan years beginning after December 31, 2018. However, the following effective dates apply to certain provisions:

- The prohibition on suspending a participant's elective contributions as a condition of obtaining a hardship distribution may be applied as of the beginning of the first plan year beginning after December 31, 2018, even if the distribution was made in 2018. For hardship distributions made on or after January 1, 2020, a plan is not permitted to provide for a suspension period as a condition to obtaining the hardship distribution.

    - If a participant takes a hardship distribution in the latter half of 2018, the plan may be amended either to end the suspension period for contributions effective as of the beginning of the 2019 plan year, or to continue the six month suspension as scheduled. However, after the 2019 plan year, the application of a suspension period is not permitted.

- Effective for the 2019 plan year, a plan administrator may determine that a participant does not have adequate assets to meet a financial need if the participant has taken all available plan distributions. Effective for the 2020 plan year, the plan administrator must ensure that all available plan distributions have been made and that a written or electronic representation has been made by the participant regarding his or her need for liquid assets.

D. *Next Steps*

The IRS has not stated that plan sponsors may rely on the proposed regulations prior to the regulations being finalized. However, we advise plan sponsors to consider the various changes made by the regulations and proceed to implement changes that plan sponsors would like to make. Moreover, we believe plan sponsors will need to eliminate the six-month suspension rule not later than the beginning of the 2020 plan year. Plan sponsors will not be required to adopt conforming plan amendments until the IRS stipulates the applicable deadlines.

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