



Changes in Hardship Withdrawal Rules for 401(k) and 403(b) Plans – What Plan Sponsors Need to Know

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Employers who sponsor a 401(k) plan or a 403(b) plan that offers hardship withdrawals have some decisions to make. The Bipartisan Budget Act of 2018 signed into law in February 2018 revised the hardship rules for 401(k) and 403(b) plans. There were many questions about how the rules would apply, and the IRS has now answered those questions in proposed regulations issued November 14, 2018. While the regulations are *proposed*, they probably won't change significantly when issued in final form, and because the rules are effective January 1, 2019, for the calendar year plans, employers and plan administrators should consider their options and check with their service providers about implementing changes in plan operations now.

In a nutshell, the new rules make these changes:

- The requirement that participants be prohibited from making elective or employee contributions to any employer plan for six months after taking a hardship withdrawal is eliminated. Elimination is mandatory effective January 1, 2020, but can be applied as early as January 1, 2019.
- All plans must require that all other available distributions under employer plans be taken first, or a withdrawal will not be considered necessary to satisfy the hardship. But, loans are no longer required to be taken before a hardship withdrawal is taken.
- A participant applying for a hardship withdrawal must state in writing or by electronic means that he or she does not have cash or other liquid assets to satisfy the immediate and heavy financial need. The plan administrator can rely on the participant's statement unless the plan administrator has actual knowledge to the contrary.
- Previously, 401(k) plans could not distribute investment earnings accrued after 1988 on 401(k) and other contributions

eligible for a hardship withdrawal. The new rules allow investment earnings to be distributed from a 401(k) plan. This does not apply to 403(b) plans.

- The new rules allow (but do not require) 401(k) plans to distribute safe harbor match or non-elective contributions, qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) in a hardship withdrawal. This does not apply to 403(b) plans invested in custodial accounts.
- The list of deemed immediate and heavy financial needs expanded to change the deemed need for a casualty loss to ignore recent changes to the casualty loss deduction rules and to provide that any expenses and losses on account of a federally declared disaster are deemed an immediate and heavy financial need.

401(k) plans and 403(b) plans are not required to offer hardship withdrawals, but if they do, there are specific rules that must be followed. The changes to these rules allow plan sponsors and participants more flexibility, as follows:

Six-month suspension of elective contributions is eliminated.

The six-month suspension was imposed by many 401(k) plans to take advantage of the rule that a hardship withdrawal is within a “safe harbor” or is deemed necessary to satisfy a financial need if all currently available distributions and loans under employer plans have been taken and the participant was prohibited from making elective or employee contributions to any plan of the employer for six months after the hardship withdrawal. The deemed hardship rule required that participants be prohibited from making elective or employee contributions to any plan, including a nonqualified deferred compensation plan, for six months after taking a hardship withdrawal. This was intended to discourage hardship withdrawals, but now this is viewed as an impediment to important savings for retirement. Plans are prohibited from restricting contributions following hardship withdrawals made in plan years beginning on or after January 1, 2020. Plans can choose to remove the contribution restriction as early as their plan year beginning on or after January 1, 2019, and can also remove it then for participants who took a

withdrawal and were restricted from making contributions in the six months prior to January 1, 2019. The restriction on elective contributions was a complicated administrative process that often created errors in plan administration, so this change is a welcome relief and will make it easier to administer hardship withdrawals.

As a result of this elimination of the six-month suspension, many nonqualified deferred compensation plans will also need to be amended, and deferral to those plans can no longer cease when a participant takes a withdrawal from a qualified plan.

No longer required to first take a loan. Under the prior rules, if a plan wanted to take advantage of a safe harbor to determine if a withdrawal is necessary to satisfy a financial need, participants were required to take all other withdrawals and loans from employer plans. Now, all plans must require participants to take all other distributions from qualified and nonqualified plans before taking a hardship withdrawal, but it is no longer required that available plan loans be taken. Plans can continue to require that loans be taken if desired. Elimination of the loan requirement will simplify administration, but now all plans must be careful to be sure there are no available distributions under qualified or non-qualified plans maintained by the employer and its controlled group of entities before allowing a hardship withdrawal.

Note that, if the hardship processing is to be handled by a 401(k) recordkeeper and there are other qualified or non-qualified plans that allow in-service distributions, a process must be established to ensure this requirement is met.

Participant representation of no available assets to satisfy need.

Beginning no later than January 1, 2020 (for calendar year plans), a participant must be required to provide a written statement (which can be given electronically) that he or she does not have cash or other liquid assets to satisfy the immediate and heavy financial need. The plan administrator can rely on the participant's statement unless the plan administrator has actual knowledge to the contrary. Because the employer is the plan administrator, but employers often delegate approval of hardship withdrawals to a recordkeeper, the requirement that the plan administrator not know the statement is incorrect creates a potential risk. The statement replaces the

requirement that the plan determine, based on all facts and circumstances, that the participant doesn't have other resources to meet the need, which previously included mortgaging a second home. The requirement has changed from not being able to satisfy a need from any assets, to not being able to satisfy a need from any reasonably available liquid assets, thus eliminating the need for the employer to delve into a participant's personal financial situation and the participant's need to exhaust illiquid assets in a time of crisis.

Investment earnings can now be distributed. One of the biggest changes now being made is that earnings on elective contributions can be distributed in a 401(k) plan hardship withdrawal. Previously, plans were prohibited from distributing investment earnings accrued after 1988 on elective contributions in a hardship withdrawal. Only the amount of the original elective contribution could be distributed. One reason for this change is participants affected by hurricanes and wildfires need to access greater portions of their plan accounts. This change is optional, and plans can continue to restrict distributions to just contribution amounts and no earnings if desired, but most plans will likely find retaining contribution data burdensome. It does not apply to 403(b) plans, which are still prohibited from distributing investment earnings in a hardship withdrawal. New legislation could change that in the near future.

Safe harbor contributions, QNECs, and QMACs can now be distributed. Safe harbor contributions are subject to the same distribution restrictions as qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs), and QNECs and QMACs were not permitted to be distributed in a hardship withdrawal. Now, QNECs, QMACs, and safe harbor contributions can be distributed in a 401(k) plan hardship withdrawal. This change is also optional and applies only to 401(k) plans and 403(b) plans that are funded with an insurance company annuity and not a custodial account. Since many 403(b) plans use a custodial account, many 403(b) plans won't be able to distribute safe harbor contributions, QNECs, and QMACs.

Expanded list of “immediate and heavy” financial needs. The portion of regulations stating a number of needs deemed to be “immediate and heavy” have been changed in a number of ways. Catching up with a prior law change, the regulations now reflect the need could be for a spouse, child or dependent, or a primary beneficiary. The deemed heavy need for damage to a principal residence that would qualify for a casualty loss deduction has also been changed. It now states that qualification as a casualty loss will be determined without the late 2017 changes to the casualty loss deduction rules. One more automatic “immediate and heavy” need has been added: the need to cover expenses and losses on account of a federally declared disaster. The first two changes are retroactive: the beneficiary change has been in effect for some time and the IRS wanted to give relief to plans that failed to apply the new casualty loss definition after the late 2017 change in the law on casualty loss deductions.

Documentation deadlines – amendments and communication to participants. The IRS noted that amendments are required by the last day of the second year after they are added to the IRS’s Required Amendments List and all changes made in connection with the regulations, including the optional changes, will be treated as integral to the regulations and subject to the same amendment deadline. While this gives until the end of 2021 for most plans to document how they implemented these changes, the better practice would be to amend closer in time to when the change is effective. Participants should be notified of hardship withdrawals changes before or shortly after they are implemented so that hardship withdrawals are effectively available to everyone and there is no potential for discrimination in the availability of hardship withdrawals.

A related topic – substantiation of financial need. The new rules do not include any provisions regarding the IRS’s recently issued guidance on what substantiation plans must obtain of the financial need. After previously requiring that plans get copies of documents proving a hardship (medical records, closing documents for a home purchase, etc.), the IRS now says that plans may instead acquire a written description of the substantiating documents from the participant. In fact, the IRS gave model Q&As that should be asked

of participants to describe their documents in some detail as part of this process. The participant must also promise to provide the actual documents if requested in an audit of the Plan by the IRS.

Your recordkeeper may announce a change in how it processes your hardship withdrawals in response to this and may even refuse to process your hardships unless the employer moves to this new “description of documents retained” rather than obtaining the documents themselves to substantiate a request. It seems likely that participants may have trouble producing documents a couple of years after a hardship withdrawal, especially those who are no longer employed and perhaps no longer even have a plan account. If the IRS asks for substantiation documents and they cannot be obtained from participants, that could give rise to sanctions and cost involved in plan corrections. The main concern of the IRS are hardships being used as an impermissible in-service distribution. Plans that use the new substantiation method are strongly advised to require the documents be produced if there is more than one hardship request in a year, and to review hardships taken during the year and request back-up documents from a couple of participants to verify hardship distributions are only being made in compliance with the rules.

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