

JANUARY 3, 2020

HARDSHIP DISTRIBUTIONS - COMMONLY ASKED QUESTIONS AND THE ANSWERS TO THEM

At the beginning of 2019, we prepared an Alert summarizing changes that Congress and the IRS had made to the rules governing hardship distributions from 401(k) and 403(b) plans. (That Alert can be found [HERE](#).) Since then, two things have happened: First, the IRS has finalized the proposed regulations that were issued in November 2018. Second, we've gotten enough questions about hardship distributions that we thought it might be useful to collect both the questions and the answers in one place. So here we go:

Q-1. *What's the difference between a "hardship distribution" and a "hardship withdrawal"?*

A-1. There's no difference. They mean the same thing.

Q-2. *Are 401(k)/403(b) plans required to offer hardship distributions to their participants?*

A-2. No. The Internal Revenue Code authorizes, but does not require, plans to make a distribution in the event a participant experiences a hardship. So a plan sponsor has to decide whether it wants to permit hardship distributions. This decision must then be reflected in the plan document.

Q-3. *Why are there some 401(k)/403(b) plans that don't offer hardship distributions?*

A-3. In our experience, those plan sponsors that do not offer hardship distributions have reasoned as follows:

1. First, processing requests for hardship distributions requires extra work and it is easy to make a mistake, which, if not corrected in accordance with IRS guidance, could jeopardize the continued tax-favored status of the plan.
2. Second, although receiving a hardship distribution may help a participant in the short run, it may not be that helpful in the long run. The amount of the hardship distribution will normally be subject to both federal and state income taxes. If the participant is younger than age 59-1/2, an additional 10% penalty tax will also normally apply. Furthermore, taking money that was intended for use in retirement out of the plan before the participant retires necessarily means that the participant will not have as much money to retire on when the participant does retire.

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Q-4. *If that's the case, why do most 401(k)/403(b) plans offer hardship distributions?*

A-4. In our experience, most plan sponsors choose to offer hardship distributions for some combination of the following reasons:

1. First, they think that their employees will expect to be able to receive a hardship distribution if something bad happens to them;
2. Second, they are concerned that their employees will defer less money into the plan if the employees think they will be unable to access that money before retirement in the event of some financial hardship; and
3. Third, they do not feel that it is their role to oversee or limit the financial decisions made by their employees. By making hardship distributions available to their employees, they are allowing their employees to make their own choices about their personal finances.

Q-5. *Are the hardship rules the same for both 401(k) plans and 403(b) plans?*

A-5. The hardship rules for 403(b) plans are almost identical to the hardship rules for 401(k) plans, but there are some differences. Perhaps the most important difference is that, in a 401(k) plan, the earnings on a participant's 401(k) "elective deferrals" can be included in a hardship distribution. In a 403(b) plan, on the other hand, earnings on an employee's contributions cannot be included in a hardship distribution.

Q-6. *If an employee wants to receive a hardship distribution, what conditions have to be met?*

A-6. First, the plan has to permit hardship distributions.

Second, if a hardship distribution is permitted under the terms of the plan document, the IRS regulations require that the distribution be "on account of the hardship." The plan administrator will have to determine if the conditions for making a hardship distribution have been satisfied.

Q-7. *What are the conditions that have to be satisfied before a hardship distribution can be made?*

A-7. For a distribution to be a "hardship distribution," it must satisfy two conditions:

1. The distribution must be made on account of an "immediate and heavy financial need;" and
2. The amount of the distribution must not be more than is necessary to meet that need.

Q-8. *What does it mean for a distribution to be made on account of an "immediate and heavy financial need?"*

A-8. The IRS regulations list seven "safe harbor" events for a hardship distribution:

1. Expenses for medical care for the employee, the employee's spouse and dependents, or a primary beneficiary;

2. Costs related to the purchase of a principal residence for the employee;
3. Payment of tuition, related fees, and room and board costs, for the employee or the employee's spouse, children, dependents, or a primary beneficiary;
4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure of the mortgage on that residence;
5. Payments for funeral or burial expenses for the employee's parent, spouse, child, dependent, or a primary beneficiary;
6. Expenses for the repair of damage to the employee's principal residence if the damage would qualify for a casualty deduction under Code § 165, determined without regard to whether the damage was attributable to a federally declared disaster and/or the damage exceeds 10% of the employee's adjusted gross income; and
7. Expenses and losses (including loss of income) incurred by an employee on account of a federally declared disaster if the employee's principal residence or principal place of employment at the time of the disaster was located within the FEMA-designated disaster area.

The first six events were included in the previous hardship regulations but have been updated in the new hardship regulations to include "a primary beneficiary" as an individual for whom qualifying medical, education, and funeral expenses may be incurred. The seventh event is new and was added by the new hardship regulations.

These seven events are considered to be "safe harbor" events because the regulations state that a distribution that is made for one of these expenses will always be deemed to be on account of an "immediate and heavy financial need," even though the amount of the distribution still cannot be more than what is needed to meet that need.

Although it is possible to make a hardship distribution for other types of expenses, historically, few plans have been willing to take the risk of determining if the existence of other types of expenses will constitute a "hardship" as that term is used in the IRS regulations.

Q-9. *If a participant experiences a hardship, can the amount of the distribution be "grossed up" for taxes and tax penalties?*

A-9. Yes, the IRS regulations provide that a distribution may be "grossed up" to reflect "any federal, state, or local income taxes or penalties" that are "reasonably anticipated to result from the distribution."

Q-10. *Is a participant required to use other resources before receiving a hardship distribution?*

A-10. The regulations provide that a distribution will not be treated as necessary to satisfy an "immediate and heavy financial need" of an employee if the need can be met using other resources that are reasonably available to the employee.

Among other things, this means that an employee must obtain “all other currently available distributions” under the plan and under all other plans maintained by the employer, including both qualified and non-qualified plans, before the employee can be allowed to receive a hardship distribution.

Under the old regulations, an employee was also required to borrow from the plan, if a plan loan was available to the employee, unless this would be counterproductive. The new regulations say that a plan may choose to require an employee to obtain all nontaxable loans available under any plans maintained by the employer, but plans no longer have to require this.

If, however, an employee is able to meet the “immediate and heavy financial need” by borrowing from the plan, the employee, in most instances, would probably be better off borrowing from the plan instead of receiving a hardship distribution. This is because a loan will not be taxable as long as it is repaid, whereas a hardship distribution will normally be taxable and, if the participant is younger than age 59-1/2, will also be subject to the 10% penalty tax.

Finally, the preamble to the new regulations also clarifies that cash or other liquid assets do not have to be treated as being “reasonably available” to the employee for purposes of meeting the financial need if the cash or other assets are earmarked for the payment of other obligations in the near future, such as rent.

Q-11. *How does a plan know if an employee is not able to meet the financial need resulting from a hardship event using other resources?*

A-11. For hardship distributions that are made on or after January 1, 2020, the employee must represent that he or she “has insufficient cash or other liquid assets to satisfy the need.” This representation can be made in writing or “by an electronic medium.” If this representation is made, the plan administrator is permitted to rely on it unless the plan administrator has “actual knowledge to the contrary.”

This is simpler than the rule under the old regulations. Under the old regulations, a plan administrator was supposed to determine if “other resources” that were “reasonably available to the employee,” such as a commercial loan or a “vacation home,” would be adequate to meet the employee’s financial need. This determination was supposed to be made “on the basis of all the relevant facts and circumstances,” although the old regulations also provided that an employer could rely on an employee’s representation that the need “was not capable of being relieved from other resources that were reasonably available to the employee” unless the employer had “actual knowledge to the contrary.”

Q-12. *Are 401(k)/403(b) plans still required to “suspend” an employee’s contributions following a hardship distribution?*

A-12. No. Under the old regulations, plans were required to suspend a participant’s contributions for a period of six months following a hardship distribution. Under the new regulations, plans will be prohibited from suspending contributions for hardship distributions that are made on or after January 1, 2020. A transition rule applies for hardship distributions that were made in 2019. Under the transition rule, plans may choose to continue suspending contributions or they may choose to follow the new rule and not suspend contributions.

This is an important change. It will simplify plan administration and will eliminate the common “operational error” of failing to suspend contributions following a hardship distribution and/or of failing to restart those contributions at the end of the suspension period.

It will also benefit participants by making it easier for them to start rebuilding the balance in their plan account following their receipt of a hardship distribution.

Q-13. *Can hardship distributions be repaid?*

A-13. Unlike a loan, money that is received as a result of a hardship distribution generally cannot be repaid. The word “generally” is part of the answer because Congress has allowed hardship distributions to be repaid if they were received as a result of a certain specific disaster, such as the 2017 hurricanes or the 2018 California wildfires, if certain other conditions are met, and if the repayment is made within three years after receipt. A participant who has received such a distribution is permitted to repay the money into an IRA. The plan that has made such a hardship distribution is not required to accept the repayment.

Q-14. *Will plan amendments be required?*

A-14. Yes. Any plan that permits hardship distributions will need to be amended to reflect the new regulations.

Q-15. *When will the amendments need to be adopted?*

A-15. The deadline for adopting plan amendments is December 31, 2021. Between now and the time you amend your plan document, you need to follow the new hardship distribution rules in “operating” your plan. You will need to keep careful track of how you operate your plan so that the amendment will accurately reflect what you have done.

If you have questions regarding these Q&As regarding hardship distributions, please feel free to contact Eric Namee, Steven Smith, Brad Schlozman, or Ruhe Rutter at (316) 267-2000.