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Welcome Changes to Hardship Distribution Rules

Once funds have been put into a 401(k) or 403(b) plan, the normal rule is that they cannot be withdrawn by the participant while the participant is still employed. There are, however, several exceptions to this general rule, including an exception that allows plans to make distributions "on account of hardship."

When Congress enacted the Bipartisan Budget Act of 2018, it made changes to the hardship distribution rules. These changes are summarized in a previous **Alert** (dated August 8, 2018). The proposed IRS regulations that were issued in November 2018 take these changes a step further. Although these new IRS regulations are not, technically, "final" regulations, portions are applicable now.

Hardship Distributions – Permitted But Not Required

Plans are not required to permit hardship distributions. Many employee benefit practitioners discourage plan sponsors from permitting them due to the complexity of administering them correctly, the resulting risk of an "operational error," and the negative impact they often have on participants (i.e. paying taxes and penalties on the distribution, plus reducing money saved for retirement). However, many 401(k) and 403(b) plans, particularly larger plans, do permit them.

Brief Background – Conditions for Receiving a Hardship Distribution

Under the Treasury Regulations, plans that permit hardship distributions cannot approve a hardship distribution unless each of the following conditions is met:

- A participant has an "immediate and heavy financial need" as a result of certain types of expenses, such as unreimbursed medical expenses, funding to prevent eviction from a residence, or expenses for repairing damage to the participant's home;
- The distribution is necessary for the participant to meet that financial need;
- The amount of the distribution does not exceed the amount necessary to meet that need; and
- The participant lacks other resources to meet that need.

These conditions themselves have not changed; however, changes made over the past year affect how some of these conditions are applied.

Overview of Recent Changes

The changes that Congress and the IRS have made over the past year to the rules governing hardship distributions may be summarized as follows:

1. Plans are no longer required to "suspend" a participant's contributions to the plan if the participant has received a hardship distribution;

2. Hardship distributions can now include earnings on a participant's 401(k) "elective deferrals" (note that this change does not apply to 403(b) plans);

3. Participants are no longer required, as a condition of receiving a hardship distribution, to either take out a plan loan first or else show that a plan loan would not be adequate to meet their financial need; and

4. The standards that participants must meet in order to show that they have experienced an "immediate and heavy financial need" have been relaxed.

These changes are discussed in more detail below.

Change #1 – Suspension of Contributions No Longer Required

Under the old hardship rules, if a participant had received a hardship distribution, a 401(k) or 403(b) plan was required to "suspend" any new contributions by that participant for six months. (This requirement technically applied only if a plan was following the IRS "safe harbor" rules for hardship distributions, but almost all plans do follow the "safe harbor" rules in our experience.)

The apparent thinking was that this would cause participants to realize that they were making an important decision and that it would discourage them from thinking of their 401(k) or 403(b) account as a type of "rainy day" fund.

In the real world, however, Congress felt that the actual impact was to get participants out of the habit of saving for their retirement at a time when, if anything, they needed to be saving more money in order to make up for the money they had just withdrawn.

Congress changed this rule when it enacted the Bipartisan Budget Act of 2018 and the IRS made additional changes in proposed regulations that were issued in November 2018. In light of these statutory and regulatory changes:

- Beginning in 2020, 401(k) and 403(b) plans will <u>not</u> be permitted to suspend contributions following a hardship distribution.

- For hardship distributions made in 2019, plans can choose whether contributions will or will not be suspended.

- For suspensions resulting from hardship distributions made in 2018, plans can choose whether the suspension will be left in place until the six-month period has expired, or plans can lift the suspension and allow contributions to resume as of January 1, 2019.

These are welcome changes. Allowing contributions to continue after a hardship distribution has been made will help prevent participants from getting out of the habit of saving and will allow them to start rebuilding their account balance. It will also eliminate two of the most common mistakes in administering 401(k) and 403(b) plans:

- Failing to suspend contributions after a hardship distribution has been made; and

- Forgetting to resume contributions once the six-month suspension period is over.

Change #2 – Hardship Distributions Can Include Earnings

Under the old hardship rules, the 401(k) elective deferrals contributed by a participant could be distributed to that participant in the event of a hardship, but the *earnings* on those elective deferrals could not be distributed.

The new rules allow earnings on elective deferrals to be distributed in the event of a hardship. The old rule represented an exception to the general rule that earnings were subject to whatever distribution restrictions applied to the underlying type of contributions. By removing this exception, the rules have been simplified and the risk of a mistake being made has been reduced.

Additionally, the new rules also allow plans to include "qualified nonelective contributions," "qualified matching contributions," and the earnings on those contributions in a hardship distribution.

Please note that, due to what appears to be a technical glitch in the legislation, this change does not apply to 403(b) plans.

Change #3 – Participants Are Not Required to Take Out a Plan Loan

Under the old hardship rules, before participants could receive a hardship distribution, they had to show either that they had already borrowed money from the plan or that the plan loans available to them would not be adequate to meet their financial need.

The new rules remove this requirement. This will simplify the process of reviewing and approving requests for a hardship distribution.

Change #4 – Simplified Standards for Showing Financial Need

The new rules expand the list of expenses that will automatically be deemed to give rise to an "immediate and heavy financial need." For example, a hardship distribution can be made if a participant's residence or principal place of employment was within a federally declared disaster area as of the date of a disaster.

Additionally, for those plans that apply a "facts and circumstances test" in reviewing a request for a hardship distribution, the new rules simplify the application of that test by allowing plans to rely on a participant's statement, with no further investigation of the facts, that the hardship distribution is needed to meet the "financial need."

Timing and Plan Amendments

Most of these changes can be *implemented* immediately. Plan amendments will be required, but the proposed regulations are unclear as to the timing. For individually designed plans, it is likely they will not be due until sometime in 2021. For plans that utilize IRS preapproved prototype documents (which is most plans), the deadline may be sooner. No amendment deadline has yet been set for 403(b) plans. We are hoping for clarity when the Treasury finalizes the regulations.

If you have adopted a 401(k) or 403(b) plan using a document prepared by our Firm and your plan permits hardship distributions, we will contact you when the time comes to move forward on adopting plan amendments.

In the meantime, if you have any questions as to how these new rules affect your 401(k) or 403(b) plan, please do not hesitate to contact Eric Namee, Steven Smith, or Brad Schlozman at (316) 267-2000.

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