Final hardship withdrawal regulations issued – where do we stand

大成 DENTONS

October 8, 2019

The Bipartisan Budget Act of 2018, signed into law in February 2018, made several changes to the rules governing hardship withdrawals from 401(k) and 403(b) plans. Questions regarding these new rules were finally resolved when the Internal Revenue Service (IRS) issued final hardship withdrawal regulations on September 23, finalizing proposed regulations issued in November.

Overview

The final regulations retain the basic rules that, in order to constitute a hardship withdrawal, the withdrawal must be both (1) made on account of an immediate and heavy financial need and (2) necessary to satisfy the financial need.

Immediate and heavy financial need

As under prior law, the final regulations permit a plan to determine whether a withdrawal is on account of an immediate and heavy financial need, either by applying a facts and circumstances test or by limiting withdrawals to specified safe harbor events. The final regulations retain the existing safe harbor events and add a new event for losses incurred as the result of certain federally declared disasters. A plan may permit hardship withdrawals for some or all of these events. Specifically, under the safe harbor option, the following are deemed to present an immediate and heavy financial need:

- Expenses for (or necessary to obtain) medical care for the employee, the employee’s spouse or dependents or the employee’s primary beneficiary
- Costs directly related to the purchase of the employee’s principal residence (excluding mortgage payments)
- Payment of tuition, related educational fees and room and board expenses for the next 12 months for the employee, the employee’s spouse, child or dependent, or for the employee’s primary beneficiary
- Payments necessary to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage on that residence
- Payments for burial or funeral expenses for the employee’s deceased parent, spouse, child or dependent, or for his or her deceased primary beneficiary
- Expenses for the repair of damage to the employee’s principal residence that would qualify for the casualty deduction under Code Section 165 (determined without regard to Code Section 165(h)(5) and whether the loss exceeds 10 percent of the employee’s adjusted gross income)

Note: In the Tax Cuts and Jobs Act of 2017, Congress amended Code Section 165 effective January 1, 2018, to limit the deduction for casualty losses to those attributable to a federally declared disaster. This had the unintended effect of also restricting hardship withdrawals under 401(k) and 403(b) plans to losses in connection with federally declared disasters. The final regulations remove this limitation for hardship withdrawal purposes, essentially returning this event to its pre-2018 meaning. As most plans reference Code Section 165 generally, most will need to be amended to clarify that withdrawals are not limited to federally declared disasters.

- Expenses and losses incurred by the employee on account of a disaster declared by the Federal Emergency Management Agency (FEMA), provided the employee's principal residence or principal place of employment at the time of the disaster was located in the area designated by FEMA for assistance

Note: This new provision is similar to relief routinely issued by the IRS following most major disasters ("disaster relief"), but is narrower in three main respects: (1) the new provision addresses only expenses of the employee who lives or works in the disaster area, and not those of the employee's relatives and dependents, as is commonly included in disaster relief; (2) the new provision does not contain a deadline by which a withdrawal request must be made, as is typically imposed by disaster relief; and (3) normal plan amendment deadlines apply, rather than special extended deadlines normally provided in disaster relief. With the issuance of this new hardship event, the IRS has indicated that it does not expect that disaster relief announcements will be needed in the future.

Necessary to satisfy the financial need

The final regulations eliminate the facts and circumstances option previously available and now provide that this prong of the test will be satisfied only if all of the following three requirements are satisfied:

- The employee has obtained all other currently available distributions, other than hardship distributions, under the plan and all other deferred compensation plans, whether qualified or nonqualified, of the employer
- The employee has provided to the plan administrator a representation in writing (or electronically) that he or she has insufficient cash or other liquid assets reasonably available to satisfy the need
- The plan administrator does not have actual knowledge that is contrary to the employee's representation

Expanded sources

The final regulations reflect the change in the Bipartisan Budget Act that permits qualified nonelective contributions (QNECs), qualified matching contributions (QMACs) and earnings on salary deferrals, QNECs and QMACs to be withdrawn on account of hardship. The regulations confirm that safe harbor contributions may also be withdrawn, as they are subject to the same rules as QNECs and QMACs.

The final regulations also clarified that, although the new rules generally apply equally to 403(b) plans, earnings on salary deferrals under a 403(b) plan may not be withdrawn on account of hardship, and QNECS and QMACs continue to be unavailable for hardship withdrawal if they are held in a custodial account.

Additional conditions

Pursuant to the final regulations, a plan may impose additional conditions on the receipt of hardship withdrawals, but may not provide for a suspension of the employee's salary deferral contributions on or after January 1, 2020. For

instance, a plan may continue to require loans to be taken before a hardship withdrawal, even though this is no longer required under the regulations.

Effective dates

The changes implemented by the final regulations are generally effective for distributions on or after January 1, 2020, but provide flexibility for earlier application. (Note that the final regulations, unlike the proposed regulations, do not tie the effective date to plan years. Thus, non-calendar year plans may have to implement certain changes mid-year.) Specifically:

- Salary deferrals may not be suspended for distributions on or after January 1, 2020, but this suspension could have been eliminated as early as the first day of the plan year beginning after December 31, 2018, even if the withdrawal was made in the prior plan year. For instance, a calendar year plan may provide that an employee who receives a hardship withdrawal in the last half of 2018 will have his or her salary deferrals suspended only until January 1, 2019, or may continue to apply the originally scheduled six-month suspension.
- The loan requirement can be eliminated as early as plan years beginning after December 31, 2018. As this change is voluntary, however, a plan sponsor may choose to continue to require a participant to obtain a loan before a hardship withdrawal.
- The expansion of sources available for hardship withdrawals is effective January 1, 2020. Thus, these sources could not be withdrawn before January 1, 2020. A plan may continue to prohibit withdrawal of these additional sources.
- The new safe harbor event for FEMA-declared disasters can be applied as early as the first day of the plan year beginning after December 31, 2018.
- The certification requirement must be implemented no later than January 1, 2020, but could have been implemented as early as the first day of the plan year beginning after December 31, 2018.

Timing of amendments

Plan amendments to address the hardship withdrawal rule changes are subject to the normal amendment deadline set forth in Rev. Proc. 2016-37. This means, for example, that individually designed, nongovernmental plans must be amended by the end of the second calendar year that begins after the issuance of the IRS' Required Amendments List that includes the changes. So, if these changes appear on the 2019 Required Amendments List, the amendment must be adopted by December 31, 2021, for calendar-year plans.

The IRS noted that, per Rev. Proc. 2017-18, the amendment deadline for 403(b) plans is March 30, 2020, but also noted that it is considering extending that deadline for purposes of amendments for changes in the hardship withdrawal rules.

Takeaways

Now that the final regulations have been issued, plan sponsors should take immediate steps to:

- Consider how hardship withdrawals will be made available going forward in light of the rule changes. This will require discussions with the plan's record keeper, as these decisions may hinge on the provisions of the particular

plan and the record keeping systems of the vendor.

- Understand how hardship withdrawals were administered during 2018 and 2019, so that plan amendments can adequately reflect administration of the plan. Again, this will require discussions with the plan's record keeper, as it likely made certain decisions unilaterally during this transition period.
- Make sure the plan is amended within the required time frame to reflect how hardship withdrawals have been and will be administered. Despite the extended deadline, we strongly recommend that the amendment be prepared and adopted as soon as possible while the complexities of the issue are fresh.
- Review the summary plan description to determine whether modifications are necessary.

Dentons' Employee Benefits and Executive Compensation group is ready to help employers understand the requirements and design opportunities under the final regulations and prepare appropriate plan amendments.

Your Key Contacts

Katharina E. Babich
Partner, Kansas City
D +1 816 460 2612
katharina.babich@dentons.com

Andrew Dalin
Counsel, New York
D +1 212 768 6895
andrew.dalin@dentons.com

Phillip Moderson
Managing Associate,
Kansas City
D +1 816 460 2489
M +1 913 638 5848
phillip.moderson@dentons.com

© 2021 Dentons. Dentons is a global legal practice providing client services worldwide through its member firms and affiliates. Please see dentons.com for Legal Notices.