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Final Regulations for Hardship Distributions



The Internal Revenue Service ("IRS") has issued final regulations on hardship distributions from 401(k) plans. The final regulations amend the rules relating to hardship distributions from Code Sec. 401(k) plans and reflect statutory changes affecting Code Sec.

401(k) plans, including changes made by the Bipartisan Budget Act of 2018. The final regulations are substantially similar to the [proposed regulations](#).

Excerpt from the final regulations are below.

Overview

The final regulations update the section 401(k) and (m) regulations to reflect: (1) the enactment of (a) sections 41113 and 41114 of BBA 2018, (b) sections 826 and 827 of PPA '06, and (c) section 105(b)(1)(A) of the HEART Act; and (2) the application of the hardship distribution rules in light of the modification to the casualty loss deduction rules made by section 11044 of the TCJA. The final regulations are substantially similar to the proposed regulations. Plans that complied with the proposed regulations will satisfy the final regulations.

Deemed Immediate and Heavy Financial Need

The final regulations, like the proposed regulations, modify the safe harbor list of expenses in existing §1.401(k)-1(d)(3)(iii)(B) for which distributions are deemed to be made on account of an immediate and heavy financial need by: (1) adding “primary beneficiary under the plan” as an individual for whom qualifying medical, educational, and funeral expenses may be incurred; (2) modifying the expense listed in existing §1.401(k)-1(d)(3)(iii)(B)(6) (relating to damage to a principal residence that would qualify for a casualty deduction under section 165) to provide that for this purpose the limitations in section 165(h)(5) (added by section 11044 of the TCJA) do not apply; and (3) adding a new type of expense to the list, relating to expenses incurred as a result of certain disasters.

The effect of the new safe harbor expense differs from the disaster-relief announcements in three main respects.

First, only disaster-related expenses and losses of an employee who lived or worked in the disaster area will qualify for the new safe harbor expense, and not, as under the disaster-relief announcements, expenses and losses of the employee's relatives and dependents. The Treasury Department and IRS have concluded that limiting distributions only to those employees directly affected by a disaster is consistent with the purposes underlying the Code's hardship distribution provisions. This better aligns with the relief given to affected individuals under section 7508A for similar disasters.

Second, unlike under the disaster-relief announcements, there is no specific deadline by which a request for a disaster-related hardship distribution must be made and no specific authority to relax certain procedural requirements established by the plan administrator or plan terms. (It is expected that plan administrators will be flexible in interpreting plan terms requiring documentation relating to the hardship when processing hardship distribution requests during the difficult circumstances following a disaster).

Third, unlike under the disaster-relief announcements, there is no extended deadline for plan sponsors to add disaster-related distribution or loan provisions to the plan. In the absence of such an extended deadline, a plan sponsor that does not choose to add disaster-related hardship distribution provisions as part of an amendment reflecting the final regulations but instead chooses to wait until a disaster occurs to add those provisions (or to add a loan provision) would need to adopt a plan amendment by the end of the plan year the amendment is first effective.

Making expenses related to certain disasters a safe harbor expense is intended to eliminate any delay or uncertainty concerning access to plan funds that might otherwise occur following a major disaster. Accordingly, the Treasury Department and IRS expect that no more disaster-relief

announcements will be needed. However, the Treasury Department and IRS are considering separate guidance to address delayed amendment deadlines when the new safe harbor expense or loan provisions are added to a plan at a later date in response to a particular disaster.

Distribution Necessary to Satisfy Financial Need

Pursuant to sections 41113 and 41114 of BBA 2018, the final regulations, like the proposed regulations, modify the rules for determining whether a distribution is necessary to satisfy an immediate and heavy financial need by eliminating (1) any requirement that an employee be prohibited from making elective contributions and employee contributions after receipt of a hardship distribution and (2) any requirement to take plan loans prior to obtaining a hardship distribution. In particular, the final regulations, like the proposed regulations, eliminate the safe harbor in existing §1.401(k)-1(d)(3)(iv)(E), under which a distribution is deemed necessary to satisfy the financial need only if elective contributions and employee contributions are suspended for at least 6 months after a hardship distribution is made and, if available, nontaxable plan loans are taken before the hardship distribution is made.

The proposed regulations eliminate the rules in existing §1.401(k)-1(d)(3)(iv)(B) (under which the determination of whether a distribution is necessary to satisfy a financial need is based on all the relevant facts and circumstances) and provide one general standard for determining whether a distribution is necessary. Under this general standard, a hardship distribution may not exceed the amount of an employee's need (including any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution), the employee must have obtained other available, non-hardship distributions under the employer's plans, and the employee must provide a representation that he or she has insufficient cash or other

liquid assets available to satisfy the financial need. A hardship distribution may not be made if the plan administrator has actual knowledge that is contrary to the representation. These modifications are adopted in the final regulations with the changes described later in this preamble relating to employee representations and the type of plans subject to the prohibition on suspensions.

The proposed regulations provide that the employee representation may be made “in writing, by an electronic medium, or in such other form as may be prescribed by the Commissioner.” The final regulations clarify that a verbal representation via telephone could be used if it is recorded. This method is acceptable, by referencing the definition of “electronic medium” at §1.401(a)-21(e)(3).

Expanded Sources for Hardship Distributions

Pursuant to section 41114 of BBA 2018, the final regulations, like the proposed regulations, modify existing §1.401(k)-1(d)(3) to permit hardship distributions from section 401(k) plans of elective contributions, QNECs, QMACs, and earnings on these amounts, regardless of when contributed or earned.

Section 403(b) Plans

Section 1.403(b)-6(d)(2) provides that a hardship distribution of section 403(b) elective deferrals is subject to the rules and restrictions set forth in §1.401(k)-1(d)(3); accordingly, the preamble to the proposed regulations states that the new rules relating to a hardship distribution of elective contributions from a section 401(k) plan generally apply to section 403(b) plans.

Applicability Dates

The changes to the hardship distribution rules made by BBA 2018 are effective for plan years beginning after December 31,

2018. The final regulations provide plan sponsors with a number of applicability-date options. Although presented differently in the proposed regulations, the options available to plan sponsors under the final regulations are the same as those available under the proposed regulations.

In response to a comment on the proposed regulations requesting clarity regarding which rules apply during 2019, the final regulations provide that §1.401(k)-1(d)(3) applies to distributions made on or after January 1, 2020 (rather than, as in the proposed regulations, to distributions made in plan years beginning after December 31, 2018). However, §1.401(k)-1(d)(3) may be applied to distributions made in plan years beginning after December 31, 2018, and the prohibition on suspending an employee's elective contributions and employee contributions as a condition of obtaining a hardship distribution may be applied as of the first day of the first plan year beginning after December 31, 2018, even if the distribution was made in the prior plan year. Thus, for example, a calendar year plan that provides for hardship distributions under the pre-2019 safe harbor standards may be amended to provide that an employee who receives a hardship distribution in the second half of the 2018 plan year will be prohibited from making contributions only until January 1, 2019 (or may continue to provide that contributions will be suspended for the originally scheduled 6 months).

If the choice is made to apply §1.401(k)-1(d)(3) to distributions made before January 1, 2020, the new rules requiring an employee representation and prohibiting a suspension of contributions may be disregarded with respect to those distributions. To the extent early application of §1.401(k)-1(d)(3) is not chosen, the rules in §1.401(k)-1(d)(3), prior to amendment by this Treasury decision, apply to distributions made before January 1, 2020, taking into account statutory changes effective before 2020 that are not reflected in that regulation.

In addition, the revised list of safe harbor expenses may be applied to distributions made on or after a date that is as early as January 1, 2018. Thus, for example, a plan that made hardship distributions relating to casualty losses deductible under section 165 without regard to the changes made to section 165 by the TCJA (which, effective in 2018, require that, to be deductible, losses must result from a federally declared disaster) may be amended to apply the revised safe harbor expense relating to casualty losses to distributions made in 2018, so that plan provisions will conform to the plan's operation. Similarly, a plan may be amended to apply the revised safe harbor expense relating to losses (including loss of income) incurred by an employee on account of a disaster that occurred in 2018, provided that the employee's principal residence or principal place of employment at the time of the disaster was located in an area designated by the Federal Emergency Management Agency for individual assistance with respect to the disaster.

Plan Amendments

The Treasury Department and IRS expect that plan sponsors will need to amend their plans' hardship distribution provisions to reflect the final regulations, and any such amendment must be effective for distributions beginning no later than January 1, 2020. The deadline for amending a disqualifying provision is set forth in Rev. Proc. 2016-37, 2016-29 I.R.B. 136. For example, with respect to an individually designed plan that is not a governmental plan, the deadline for amending the plan to reflect a change in qualification requirements is the end of the second calendar year that begins after the issuance of the Required Amendments List (RAL) described in section 9 of Rev. Proc. 2016-37 that includes the change; if the final regulations are included in the 2019 RAL, the deadline will be December 31, 2021.

A plan provision that does not result in the failure of the plan to satisfy the qualification requirements, but is

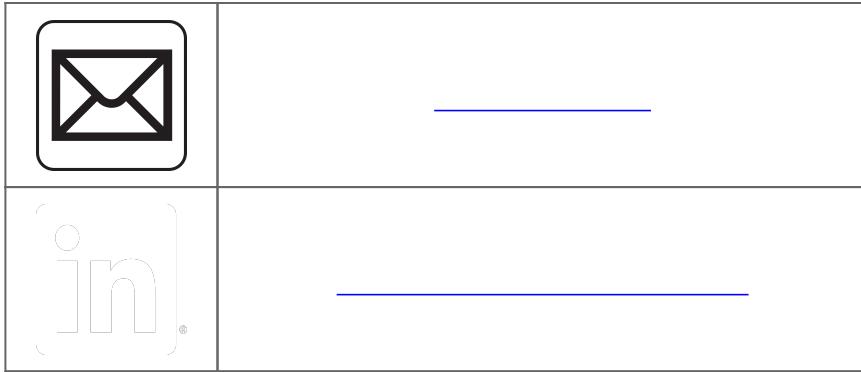
integrally related to a qualification requirement that has been changed in a manner that requires the plan to be amended, may be amended by the same deadline that applies to the required amendment. The Treasury Department and IRS have determined that a plan amendment modifying a plan's hardship distribution provisions that is effective no later than the required amendment, including a plan amendment reflecting one or more of the following, will be treated as amending a provision that is integrally related to a qualification requirement that has been changed: (1) the change to section 165 (relating to casualty losses); (2) the addition of the new safe harbor expense (relating to expenses incurred as a result of certain federally declared disasters); and (3) the extension of the relief under Announcement 2017-15, 2017-47 I.R.B. 534, to victims of Hurricanes Florence and Michael that was provided in the preamble to the proposed regulations. Thus, in the case of an individually designed plan, the deadline for such an integrally related amendment will be the same as the deadline for the required amendment (described in the preceding paragraph), even if some of the amendment provisions have an earlier effective date.



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