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IRS Finalizes New Hardship Withdrawal Rules

Greater flexibility and higher dollar amounts offer a winning formula to participants and plan sponsors.

On September 19, 2019, the Internal Revenue Service finalized amendments to current 401(k) hardship withdrawal rules, implementing changes made by the Bipartisan Budget Act of 2018. Provisions in the final regulations include a new and more flexible hardship withdrawal "safe harbor" and increase the amounts that may be removed from a 401(k) plan in a hardship withdrawal. For the most part, the new rules go into effect in 2020, although plans may apply some of them as early as this year.

Differences From 2018 IRS Proposal

While the final regulations generally track the initial proposal, the IRS did make certain changes, including clarifying that:

- The employee representation that she has insufficient cash/liquid assets only applies to cash/assets that are "reasonably available" and does not apply, for example, to amounts "earmarked for payment of an obligation in the near future (for example, rent)."
- Representation may be made in writing, electronically or orally (if recorded), e.g., in a call to a call center.
- The requirement that the plan administrator not have "actual knowledge" "does not impose upon plan administrators an obligation to inquire" (quoting the preamble to the final rule).
- The prohibition of suspensions applies only to qualified plans, not to nonqualified deferred compensation plans.

Review of Final Provisions

Background

In a 401(k) plan, amounts "attributable" to 401(k) elective deferrals generally may not be distributed earlier than severance from employment, death or disability. One exception to this rule is for distributions "upon hardship of the employee." Under the prior regulations, the maximum hardship distribution was limited to the amount of a participant's actual 401(k) contributions, without taking into account earnings, qualified matching contributions (QMACs) or qualified non-elective contributions (QNECs).

IRS regulations break the hardship distribution analysis into two separate components: (1) the distribution must be on account of an "immediate and heavy financial need," and (2) it must be "necessary to satisfy [that] financial need."

With regard to issue 1, prior regulations provided a list of "deemed immediate and heavy financial needs," including, for example, "costs directly related to the purchase of a principal residence." Let's call this the "deemed need" rule.

With regard to issue 2, prior regulations provided that a distribution was "treated as necessary to satisfy an immediate and heavy financial need" if the employee (a) made a representation that the amount is necessary (provided the employer does not have actual knowledge to the contrary), (b) had obtained all available distributions and nontaxable loans under all plans of the employer; and (c) *was prohibited from making contributions to all employer plans for at least six months* (the "six-month holdout" rule). Let's call this the "treated as necessary" rule.

Key Changes

The IRS's new regulation makes changes both to the "deemed need" and the "treated as necessary" rules and expands the kinds of contributions/earnings that may be withdrawn in a hardship withdrawal.

'Deemed Need' Rule

With respect to the "deemed need" rule, the new regulation makes three relatively limited changes:

- A participant's primary beneficiary is included among the persons for whom hardship-qualifying medical, educational and funeral expenses may be incurred.
- The "damage to a principal residence" deemed hardship is not limited by certain restrictions on casualty losses added by 2017 tax reform legislation.
- A new deemed hardship is added for expenses resulting from certain federally declared disasters.

'Treated as Necessary' Rule

The changes to the "treated as necessary" rule are generally more significant. As noted above, the prior rule required that the participant take all available loans and cease contributions for six months. Under the new regulation, a participant may take a hardship withdrawal if two conditions are satisfied:

- The participant must take all other available distributions under employer plans (qualified or nonqualified), and
- The employee must make a representation "that he or she has insufficient cash or other liquid assets reasonably available to satisfy the need." Absent actual contrary knowledge, the plan administrator may rely on this representation.

Plan May Impose Other Restrictions

Generally, the plan may impose greater restrictions on hardship withdrawals; for example, the plan could continue to require that the participant take all available loans. Beginning in 2020, however, the plan may not require that the participant suspend contributions (under any qualified plan) as a condition of taking a hardship distribution.

Removal of Restrictions on the Amount That May Be Distributed

Finally, the regulation eliminates the limitation of hardship distributions to a participant's 401(k) contributions, thereby allowing distributions that include earnings, QNECs and QMACs.

The new regulation is generally good news, providing for an easier-to-administer and more flexible set of hardship withdrawal rules while also allowing sponsors to impose more stringent rules (other than with respect to the suspension of contributions) where they deem appropriate.

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