

IRS Proposed Regulations Relax Requirements for Hardship Distributions

Tax & Benefits Alert

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The IRS recently issued proposed regulations relating to hardship distributions under 401(k) plans. The proposed regulations generally clarify or supplement recent statutory changes, including those made by the Bipartisan Budget Act of 2018. Except where noted, the rules and changes summarized herein also apply to plans of tax-exempt organizations under Section 403(b).

Background

Distributions under a 401(k) plan may be made on account of hardship only if the distribution is made for an “immediate and heavy financial need” and is “necessary to satisfy the financial need.”

Most 401(k) plans use the “safe harbor” rules under the regulations for processing hardship distribution requests. Under the safe harbor rules, a distribution is deemed to be on account of an immediate and heavy financial need if the expense for which the distribution is being requested is one of several enumerated expense items, such as certain medical care expenses, costs related to purchase of a principal residence, certain tuition expenses, certain burial expenses, and expenses for the repair of damage to the employee’s principal residence. Further, under the safe harbor rules, a distribution is deemed “necessary” to satisfy an immediate and heavy financial need if (i) the participant is prohibited from making elective contributions to the plan (and all other plans of the employer) for at least six months after receiving the hardship distribution, and (ii) the participant obtains all other currently available distributions and nontaxable loans under the plan (and all other plans of the employer) before receiving a hardship distribution.

Historically, hardship distributions (regardless of whether pursuant to the safe harbor rules) generally could not be taken from safe harbor contributions, QNECs, or QMACs.

The Proposed Regulations

The proposed regulations clarify and supplement recent changes in the law as follows:

- As of January 1, 2020, the six-month suspension on employee elective contributions is eliminated (while previously a safe harbor item, such a provision appears to be precluded outright by the proposed regulations).
- As of January 1, 2019, a plan need not require that an employee obtain all nontaxable employer plan loans as a

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condition to meeting the above safe harbor (a plan may retain this rule on a discretionary basis).

- Effective for plan years beginning on or after January 1, 2018:
 - The safe harbor expense for repairing damage to an employee's principal residence that would qualify for the casualty deduction under IRC 165 is modified to clarify that for purposes of qualifying as a hardship expense, the new limitation on the IRC 165 deduction under the Tax Cuts and Jobs Act of 2017 (which, for taxable years 2018 through 2025, limits the deduction for a personal casualty loss to those attributable to a federally declared disaster) does not apply; and
 - The safe harbor list of expenses is expanded to include losses incurred in a disaster if the principal place of residence/employment was located in a FEMA-designated disaster area.
- The safe harbor list of expenses reflects that a "primary beneficiary under the plan" is an individual for whom a qualifying medical, education, or funeral expense may be incurred (this generally reflects a similar provision of the Pension Protection Act of 2006, which has been in effect for years).
- Effective for plan years beginning on or after January 1, 2019, the sources of funds for hardship distributions are expanded to include QNECs, QMACs, safe harbor contributions, and earnings on those amounts, regardless of when they were contributed or earned (but a plan may retain the restriction on these sources of funds on a discretionary basis). This expansion of the sources of funds, however, does not apply to 403(b) plans.

Finally, the proposed regulations eliminate the rule under the non-safe harbor standard that currently requires a plan sponsor to determine whether a distribution is necessary to satisfy a financial need based on all the relevant facts and circumstances, and have provided one general standard for determining whether a distribution is necessary. Under this general standard, a hardship distribution may not exceed the amount of a participant'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 participant must have obtained other available distributions under the employer's plans; and the participant must represent that he or she does not have sufficient cash or liquid assets to alleviate the hardship. Plan sponsors must accept participant representations after January 1, 2020, but they are optional in the interim.

Actions by Plan Sponsors

Except for the required elimination of the six-month contribution suspension as of January 1, 2020, plan sponsors generally will have flexibility with implementing the above changes after the proposed regulations are finalized. Once the regulations are finalized, plan sponsors will have a fair amount of time to actually amend their plan documents to reflect these changes. Nevertheless, plan sponsors should be reviewing their hardship distribution provisions and procedures in light of the proposed regulations to ensure that required changes will be timely implemented and to adjust their procedures to reflect any discretionary changes that they wish to implement.