WHAT'S NEW ABOUT 401(k) PLAN HARDSHIP WITHDRAWALS?

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I. OVERVIEW OF 401(k) PLAN HARDSHIP DISTRIBUTION RULES

A. 401(k) and 403(b) plans (referred to in this outline only as 401(k) plans) must generally prohibit in-service distribution of participant deferrals until age 59½.

1. The principal exception to the prohibition is for "hardship distributions."

2. A 401(k) plan's failure to adhere to IRS hardship distribution rules not only affects the participant requesting the withdrawal, but it can lead to the plan's disqualification by the IRS.

B. 401(k) plans often provide for hardship distributions, but they are not required to permit these distributions,

1. The Plan Sponsor Council of America reports that approximately 84% of all 401(k) plans provide for hardship distributions.

2. Without hardship distribution provisions, participants may not have access to their deferrals.

3. This may have a chilling effect on participants agreeing to defer.

C. For a distribution to qualify as a hardship distribution two tests must be met:

1. The participant must have an "immediate and heavy financial need."

2. The amount distributed must be necessary "to satisfy the financial need."

D. The need of a participant also includes the need of a participant's:

1. Spouse or dependent.

2. Non-spouse or non-dependent beneficiary.

E. What constitutes an immediate and heavy financial need?

1. Most plans utilize the IRS "safe harbor" standards for determining if this test is met.

2. The six (6) situations identified under the safe harbor definition include:

a. Expenses for medical care that are deductible under IRC Section 213(d) and are not reimbursed by insurance.

i. Not subject to the requirement that they exceed a certain percentage of income.

ii. Expenses of a spouse, dependent and primary beneficiary also qualify.

b. Costs related to the purchase of a primary residence.

i. May not be used to purchase a vacation home.

ii. May be used to build a new primary residence.

c. Expenses for up to twelve (12) months of post-secondary education.

i. Includes tuition, fees, room and board.

ii. May be used for the participant's spouse, dependent and primary beneficiary.

d. Amounts necessary to prevent eviction or foreclosure from a primary residence

i. Participant must have a notice of the proceeding.

ii. Simply being late on a payment or rent is inadequate.

e. Burial or funeral expenses for participant's deceased parents, spouse, children and/or primary beneficiaries.

f. Expenses for repair of damages to participant's primary residence.

i. That are deductible under IRC Section 165 as a casualty loss.

ii. See below for a discussion of the impact of Tax Cuts and Jobs Act of 2017 ("TCJA") on this provision.

3. Other situations or circumstances can also be specified in a 401(k) plan as an immediate and heavy financial need; however, most plans simply use the IRS safe harbor standards.

F. A distribution is not considered necessary to satisfy an immediate and heavy financial need if the employee has other resources available to meet the need; such as:

1. Assets of a spouse or minor children.

2. The participant has obtained all other distributions and/or loans available under the plan or any other plans of the employer.

Keep in mind that many 401(k) plans and profit sharing plans provide for in-service distribution of employer contributions at certain ages or under circumstances that are less onerous than those specified for hardships.

3. The employee is prohibited from making future deferrals for at least six (6) months.

4. A participant need not use a resource if it makes their financial situation worse.

   a. For example, taking cash advances on credit cards or utilizing every dollar of savings which would likely adversely affect the ability to obtain a mortgage on a new primary residence.

   b. On the other hand, inconvenience or incurring fees or costs to get to a resource is not a good reason.

5. See below for a discussion of the impact of the Bipartisan Budget Act of 2018 ("BBA") on these provisions.

G. What is the maximum amount that may be distributed as a hardship distribution?

1. The maximum distribution amount includes all elective deferrals (both traditional and Roth), but does not include other components of a participant 401(k) account. The following are <u>not</u> eligible for hardship distributions.

   a. Earnings on a 401(k) account; however, see below for a discussion of the impact of BBA:

   b. Qualified non-elective contributions ("QNECs").

c. Qualified matching contributions (“QMACs”).

2. In determining the amount needed, a participant may include amounts necessary to pay any taxes or penalties that result from the distributions.

a. Hardship distributions are not eligible for rollover.

b. Generally, the distributions to a participant under age 59½ will be subject to the 10% premature distribution tax unless it qualifies for an exception under IRC Section 72(t).

i. Qualified higher education expenses.

ii. Qualified first-time home buyer.

iii. Unreimbursed medical expenses above certain limits.

H. What obligations do employers have before authorizing hardship distributions?

1. As noted above, the failure to adhere to the hardship distribution rules could cause a 401(k) plan to be disqualified.

2. Generally, plan sponsors have an obligation to obtain some documentation supporting the reason for the hardship distribution and the amount needed.

3. Plan sponsors cannot ignore facts or information known or should reasonably be known.

a. Source documentation is best, but in some instances the plan sponsor may rely on written statements from the participant.

b. For example, a request to cover medical expenses must be denied when the plan sponsor knows the expense will be covered under the plan sponsor's company-provided medical plan.

4. See below for a discussion of the documentation that is needed in a 2017 internal memorandum issued by the IRS to its agents ("2017 Memorandum").

II. NEW LEGISLATION AND IRS GUIDANCE AFFECTING HARDSHIP DISTRIBUTIONS

A. The 2017 Memorandum now provides a clear set of substantiation guidelines for agents who audit employee plans ("EP agents") to determine whether a hardship distribution is "on account of an immediate and heavy financial need."

1. The 2017 Memorandum only addressed documentation for the safe harbor situations. This continues to have a chilling effect on the use of non-safe harbor standards in 401(k) plans.

2. While, the 2017 Memorandum does not have the impact of law or other formal guidance by the IRS, it is a clear statement of the guidelines that will be used by EP agents when reviewing hardship distributions.

3. The audit steps to be taken depend on whether participants submit actual source documents or summaries.

a. Submission by the participant of source documents to the employer or TPA.

i. Estimates, contracts, bills and statements from third parties must be reviewed to determine if any substantiate the hardship.

ii. Presumably, photocopies and not the original documents are adequate.

b. Submission by the participant of a summary of the information contained in the source documents.

i. If a summary of the source documents is submitted the employer or TPA must provide the employer a written notification described "on Attachment 1 prior to making a hardship distribution".

ii. The auditor is directed to determine if the summary contains the "relevant items listed on Attachment 1". **[A copy of the Attachment 1 is included with this outline.]**

iii. If the notification or summary is incomplete or inconsistent on its face, source documents should be requested.

iv. If more than two hardship distributions were requested during a plan year for a participant, source documents may be requested.

v. If a TPA is obtaining the summaries directly from participants, reports should be submitted to the employer at least annually describing the hardship distributions being made.

c. An example of the detailed information required by Attachment 1 for the purchase of a primary residence.

i. Will this be the participant's primary residence?

ii. Address of the primary residence.

iii. Purchase price.

iv. Types of costs and expenses being covered (down payment, closing costs, title fees, etc.).

v. Name and address of the lender.

vi. Date of purchase agreement.

vii. Expected closing date.

4. One major question remains; what happens if the summary approach is utilized, the auditor requests source documents and the employee is unable or unwilling to produce the source documents?

a. The notification requires the participant to agree to preserve the source documents and produce them on request.

b. Is the plan's qualification put "at risk"?

B. BBA will make it easier to withdraw larger amounts as hardship distribution for plan years beginning in 2019 (for better or worse).

1. The new changes include:

a. Hardship distributions may now be made from account earnings, QNECs and QMACs in addition to employee deferrals.

b. Requires the IRS to modify regulations to remove the requirement that a six month suspension of deferrals

must occur after receipt of a hardship distributions by a participant.

c. Permit hardship distributions to occur regardless of whether a participant has first obtained available plan loans.

2. These new rules are not mandatory and employers can choose to continue to utilize rules limiting the amounts available and qualification requirements for hardship distributions.

C. TCJA had a number of provisions affecting hardship distributions for expenses relating to the repair of damages to a participant's primary residence.

1. IRS Reg. Section 1.401(k)-1(d)(3)(iii)(B)(6) provides that a distribution is deemed to satisfy a participant's immediate and heavy financial need if the distribution is for expenses for the repair of damages to the employee's principal residence that would qualify for the casualty deduction under Section 165 determined without regard to whether the loss exceeds 10% of adjusted gross income.

a. TCJA did not directly amend the hardship distribution rules, but did change Section 165.

b. Instead of a wide range of casualty losses, Section 165 is now limited to only "presidentially declared disasters such as hurricanes, floods or wildfire."

c. It is possible that plans which generally utilize the safe harbor standards of determining if an immediate and heavy financial need exists, could use a non-safe harbor standard on primary residence casualties.

i. This will put greater burdens on plan administrators.

ii. This will also create greater risks of a plan's disqualification.

2. Special tax treatment was given for "qualified 2016 disaster distributions." (Spreading the tax consequence over 3 years, removing the 10% early withdrawal penalty and allowing the recontribution of the distribution for up to 3 years.)