GODFREY KAHN S.C.

Employee Benefits Flash

October 2019

John Donahue
414.287.9422
jdonahue@gklaw.com

Lynda Strehlow
Paralegal
414.287.9372
lstrehlow@gklaw.com

The information in this article is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

New hardship distribution rules for 401(k) plans

The U.S. Treasury Department has issued new regulations affecting 401(k) plans that permit hardship distributions. This summary highlights both the required and optional changes.

As in the past, the regulations only allow a hardship distribution if it "is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need." However, there are significant changes to the ways those tests are applied. The new regulations also add to the list of deemed hardships, relieve plan administrators of investigative responsibilities and expand the number of fund sources from which hardship distributions may be paid.

A 401(k) plan that allows hardship distributions must be amended, but the earliest deadline for individually designed plans would be Dec. 31, 2021. There is an earlier deadline for a plan that uses documentation preapproved by the Internal Revenue Service—the due date (including extensions) for filing the sponsor's federal tax return for the year which includes Jan. 1, 2020. However, since portions of the amendment will apply on Jan. 1, 2020, if not earlier, a plan sponsor should determine which optional changes it desires, as well as when they and the two mandatory changes will become effective. Those decisions should be recorded if a formal amendment will not be adopted until a later date.

Some plan recordkeepers have already determined which optional changes they will or will not support and the effective date of each change, so plan sponsors should coordinate with their service providers as soon as possible.

Mandatory changes

Elimination of the six-month suspension on employee contributions

Under the old regulations, a participant could not make voluntary contributions to the plan or any other plans maintained by the employer for at least six months after receiving a hardship distribution. The only exceptions were employee contributions to a health or welfare benefit plan, including those made through a cafeteria plan. However, any hardship distribution made on or after Jan. 1, 2020 must not trigger a suspension of employee contributions to the 401(k) plan or to any other qualified retirement plan. If desired, the plan sponsor may initiate this change for the plan year beginning in 2019. The plan sponsor may also choose to waive the remainder of any suspension period that commenced less than six months before the effective date of the change. For example, a six-month suspension that began on Oct. 1, 2019 can continue until March 31, 2020 or terminate on an earlier date, such as Dec. 31, 2019.

Process for determining financial need

As with the prior regulation, a plan administrator will have to determine that the requested amount does not exceed the amount necessary to satisfy the financial need, including taxes on the distribution. It must also confirm that the participant has taken any taxable distributions available from the employer's retirement and nonqualified deferred compensation plans. However, the new regulation does not require the administrator to inquire about other personal or family assets the participant might use to satisfy the need. Unless the administrator has actual knowledge to the contrary, it can rely on a participant's statement that he or she has insufficient liquid assets other than amounts already earmarked for other current obligations such as rent or outstanding

medical bills. The statement must be in writing or an electronic medium such as a website, email or a voice-response telephone system. This change is optional for hardship distributions before January 1, 2020, but mandatory thereafter.

Optional changes

Available plan distributions and loans

The prior regulations prohibited a hardship distribution until a participant had taken all available plan loans as well as all taxable distributions the participant was eligible to receive from the plan and any other qualified or nonqualified retirement plans of the employer. The distribution requirement still applies, but a plan administrator no longer needs to require a participant to take all available loans from the employer's retirement plans before receiving a hardship distribution. Eliminating the loan requirement is optional.

Deemed hardships

The new regulation recognizes for the first time that the Pension Protection Act of 2006 allowed the medical, education and funeral expenses of a participant's "primary beneficiary" to qualify as a hardship for the participant, as would such expenses incurred for the participant's spouse, children and other dependents. For this purpose, a primary beneficiary is an individual who would have a right to any part of the account upon the participant's death.

The proposed regulation backtracks on the statutory change regarding expenses for the repair of damage to a participant's principal residence. The Tax Cuts and Jobs Act of 2017 added section 165(h)(5) to the Internal Revenue Code to disallow casualty loss deductions during 2018-2025 unless they are attributable to federally declared disasters. However, the new regulation will allow a plan amendment permitting post-2017 expenses for the repair of one's residence to qualify as a hardship without a disaster declaration.

Finally, the list of deemed hardships can be expanded to include expenses and losses, including lost income, on account of a disaster declared by the Federal Emergency Management Agency (FEMA), provided the participant's principal residence or his or her principal place of employment was located in an area for which FEMA authorized individual disaster assistance.

These three optional changes can be included in retroactive amendments for any plan year beginning after 2017. As an example, a plan could allow a participant to take a hardship distribution now for the cost of having repaired damage to the participant's principal residence in 2018 plus the amount of taxes the participant will have to pay because of the distribution.

Sources available for distribution

The old regulations generally limited hardship distributions to a participant's elective deferrals and earnings attributable to such contributions at the close of the last plan year ending before July 1, 1989. The new regulation permits a plan sponsor to amend its plan to make available additional sources, including post-1988 earnings on elective deferrals, certain employer contributions and all earnings thereon.

Plan amendment

The mandatory changes and any optional ones must be incorporated in a formal plan amendment, which can be retroactive if adopted by the applicable deadline. However, if any part of the amendment will apply retroactively, all decisions and effective dates should be recorded to help assure that the amendment is consistent with actual plan operations.

If you have questions or want to discuss how these regulations could impact your organization, please contact a member of our Tax and Employee Benefits Practice Group.