Plan Distributions

Overview of IRS Notice 2002-4, Clarifying EGTRRA Provisions on 401(k) Plan Distributions Upon Severance From Employment and Hardship

EGTRRA's changes affecting hardship distributions and distributions due to severance from employment are clarified in IRS Notice 2002-4, which is summarized here.

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On December 20, 2001, the IRS issued Notice 2002-4, [2002-2 I.R.B. 298] which, among other things, provides guidance about how the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) affected hardship distributions—and distributions due to severance from employment—from 401(k) plans.

Hardship Distributions

Elective deferrals under a 401(k) plan may not be distributed prior to the occurrence of one or more specified events. One event on which distribution is permitted is the financial hardship of the employee. [I.R.C. § 401(k)(2)(B)(i)(IV)] The regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the need. [Treas. Reg. § 1.401(k)-1(d)(2)]

A distribution will be deemed to be made on account of hardship if it meets (1) the "immediate and heavy financial need" safe harbor and (2) the "necessary to satisfy the financial need" safe harbor under the regulations. [Treas. Reg. § 1.401(k)-1(d)(2)(iv)(A), (B),]

The second safe harbor provides that a distribution will be deemed necessary to satisfy an immediate and heavy financial need only if four specific requirements are met. [Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B)(1)–(4)] One such requirement is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution (called the "elective contribution prohibition period" in IRS Notice 2002-4). [Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B)(4)] The other three requirements are that (1) the distribution not exceed the amount of the employee's immediate and heavy financial need (including any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution), (2) the employee must first obtain all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer, and (3) the plan and all other plans maintained by the employer must limit the employee's elective contributions for the next taxable year to the applicable limit under Section 402(g) of the Internal Revenue Code (Code) for that year minus the employee's elective contributions for the year of the hardship distribution (called the "post-hardship contribution limit" in IRS Notice 2002-4). [Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B)(1)–(3)]

In EGTRRA Section 636(a), Congress directed the Secretary of the Treasury to revise the regulations relating to hardship distributions to reduce the minimum elective contribution prohibition period (described above) from 12 to 6 months. [EGTRRA § 636(a)(1)] The revised regulations were to be effective for years beginning after December 31, 2001. [EGTRRA § 636(a)(2)]

In Notice 2002-4, the IRS stated that the "deemed necessary" safe harbor provision in Treasury Regulations Section 1.401(k)-1(d)(2)(iv)(B) would be revised in response to Congress's directive in EGTRRA Section 636(a). IRS Notice 2002-4 specifically provides that the safe harbor requirement in Treasury Regulations Section 1.401(k)-1(d)(2)(iv)(B)(4) will be revised to reduce the elective contribution prohibition period from a period of at least 12 to 6 months. In addition, the post-hardship contribution limit in Treasury Regulations Section 1.401(k)-

1(d)(2)(iv)(B)(3) will be eliminated. Taxpayers can rely on these new rules until the IRS issues further guidance. [IRS Notice 2002-4, IV]

This revised safe harbor is effective for 2002 and later calendar years. Accordingly, the requirement that a participant's elective contributions under the plan (and all other plans maintained by the employer) be limited to the post-hardship contribution limit can be eliminated effective for 2002 and later calendar years, for participants who received hardship distributions during 2001. A 401(k) plan will not fail to comply with the hardship distribution safe harbor provisions under Treasury Regulations Section 1.401(k)-1(d)(2)(iv)(B) solely because it retains its existing post-hardship contribution limit. However, if a plan relies on the matching contribution safe harbor under Code Section 401(k)(12) or 401(m)(11), it must eliminate the post-hardship contribution limit, effective for 2002 and later calendar years, for participants who receive a hardship distribution after December 31, 2001. [IRS Notice 2002-4, IV]

Plan amendments reflecting IRS Notice 2002-4's changes in the safe harbor hardship distribution rules are integral to a qualification requirement that has been changed by EGTRRA. IRS Notice 2001-42 [2001-30 I.R.B. 70] provides a remedial amendment period for EGTRRA, during which any needed retroactive remedial EGTRRA plan amendments may be adopted. The availability of the EGTRRA remedial amendment period is conditioned on the adoption of required good-faith EGTRRA plan amendments by the end of the year in which the applicable requirements first become effective, or if later, the end of the GUST remedial amendment period. For purposes of determining whether a plan provision is a disqualifying provision under IRS Notice 2001-42 (regarding the amendment of qualified plans in compliance with EGTRRA), a plan sponsor will not fail to have adopted a timely good-faith amendment with respect to the hardship distribution safe harbor even though the amendment does not specifically eliminate the post-hardship contribution limit. IRS Notice 2001-57 [2001-38 I.R.B. 279] includes EGTRRA model amendment language to change the elective contribution prohibition period, but it does not include model amendment language to eliminate the post-hardship contribution limit. Nevertheless, the IRS has indicated that any plan sponsor that timely adopts the model amendment language to change the elective contribution prohibition period will be deemed to have eliminated the post-hardship contribution limit. However, if the plan sponsor does not timely adopt a good-faith amendment changing the elective contribution prohibition period (or adopts such a change effective for a year different from the year in which the post-hardship contribution limit is eliminated under the plan), the plan sponsor must adopt a timely good faith amendment that specifically eliminates the post-hardship contribution limit in order for the provision to be a disqualifying provision for purposes of the remedial amendment period under IRS Notice 2001-42. [IRS Notice 2002-4, IV]

Example. A plan (other than a plan that relies on the matching contribution safe harbor under Code Section 401(k)(12) or 401(m)(11)) will not fail to comply with the revised safe harbor under IRS Notice 2002-4 if it continues to prohibit elective and employee contributions for 12 months following a hardship distribution. Therefore, there is no requirement that a good-faith amendment be adopted changing this period from 12 to 6 months. However, in such case, a timely good-faith amendment adopted at a later time must include the elimination of the post-hardship contribution limit for there to be a remedial amendment period with respect to the elimination of the limit. [IRS Notice 2002-4, IV]

Distributions Upon Severance From Employment

Prior to EGTRRA, another event that would trigger distributions of elective deferrals under a 401(k) plan was an employee's separation from service. [I.R.C. § 401(k)(2)(B)(i)(I), prior to amendment by EGTRRA § 646(a)(1)(A)] Under pre-EGTRRA law, a separation from service occurred only on a participant's death, retirement, resignation, or discharge, and not, under the so-called same-desk rule, when the employee continued on the same job for a different employer as a result of a liquidation, merger, consolidation, or other, similar corporate transaction.

EGTRRA repealed the same-desk rule by amending Code Section 401(k)(2)(B)(i)(I) to replace *separation from service* with *severance from employment*. [I.R.C. § 401(k)(2)(B)(i)(I), as amended by EGTRRA § 646(a)(1)(A)] The repeal applies to distributions of elective deferrals made after December 31, 2001, regardless of when the severance from employment occurs. [EGTRRA § 646(b); Statement of Managers for Conference Agreement on H.R. 1836 (EGTRRA), at 161 (2001)] Thus, under Code Section 401(k)(2)(B)(i)(I), as amended by EGTRRA, amounts attributable to elective contributions may be distributed on the employee's severance from employment with the employer maintaining the plan. For this purpose, the employer includes all corporations and other entities treated as the same employer under Code Section 414(b), (c), (m), or (o).

An employee does not have a severance from employment if, in connection with a change of employment, the new employer maintains the 401(k) plan that covers the employee. For example, the new employer may assume sponsorship of the plan or accept a transfer of plan assets and liabilities (within the meaning of Code Section 414(l)). Alternatively, if all employees of a parent-subsidiary controlled group of corporations (within the meaning of Code Section 414(b)) are covered by a 401(k) plan and the parent sells one subsidiary to an unrelated buyer, that subsidiary would cease to be aggregated with other members of the controlled group. If, in connection with the transaction, no assets are transferred from the original parent's 401(k) plan to a plan maintained by the former subsidiary, participants in the 401(k) plan who continue employment with the subsidiary will have a severance from employment with the employer maintaining the 401(k) plan and may receive a distribution of amounts attributable to elective contributions from that plan. On the other hand, if the subsidiary maintained a 401(k) plan for its employees before the transaction and continues to do so following the transaction, the employees who continue employment with the subsidiary do not have a severance from employment with the employer maintaining the plan, and no distributions of elective deferrals will be permitted. [IRS Notice 2002-4 § III]

The sponsor of a 401(k) plan that intends to permit distributions following an employee's severance from employment must amend the plan to substitute *severance from employment* for *separation from service*. A plan may provide for the more liberalized distributions on severance from employment on or after January 1, 2002, even if the severance from employment occurred before or on January 1, 2002, and even if the distribution would not have satisfied the pre-EGTRRA rules. However, the plan does not have to be this generous. Alternatively, the plan could apply the more liberalized distribution rules only to participants who have a severance from employment on or after January 1, 2002 (or on another date specified in the plan).

A 401(k) plan will not fail to comply with Code Section 401(k)(2)(B), as amended by EGTRRA, merely because it does not permit distributions in all situations in which a participant has a severance from employment. Thus, for example, a plan could limit distributions to situations in which a participant has a separation from service or following a disposition of assets or disposition of a subsidiary that would have qualified under Code Section 401(k)(2)(B)(i)(II) and 401(k)(10)(A)(ii) and (iii) as in effect prior to the EGTRRA amendments. [*See* Rev. Rul. 2000-27, 2000-1 C.B. 1016] If a plan is not amended to provide for distributions following a severance from employment, elective contributions can be distributed only to the extent permitted by the plan. [IRS Notice 2002-4, § III]

IRS Notices 2001-42 and 2001-57 address the timing of the adoption of such an amendment. [IRS Notice 2002-4, § III]