Digging Deeper Into the New Hardship Distribution Regulations

Hardship distributions overview

As you may know, retirement plan participants generally are prohibited from taking plan distributions unless certain events occur, such as separation from service or attainment of age 59½. But employers may design plans to allow participants experiencing financial difficulties to take hardship distributions.

A participant must meet two conditions before obtaining a hardship distribution:

1) The participant must have an "immediate and heavy financial need."
2) The distribution must be necessary to satisfy that financial need.

Meeting the first condition: Determining whether there is financial need
The previous hardship regulations (adopted in 2004) offered two ways to determine financial need: the facts-and-circumstance method or the safe harbor method. Most employers chose the safe harbor method for administrative ease. This safe harbor method identified six reasons that were deemed immediate and heavy financial needs:

1) Unreimbursed medical expenses
2) Costs for purchasing a principal residence
3) Certain educational expenses
4) Payments to avoid eviction or foreclosure (principal residence)
5) Certain funeral expenses
6) Costs to repair damage to a principal residence (that would apply for the IRS casualty deduction)

As we will discuss later in this article, the final regulations add a seventh reason.

Meeting the second condition: Determining whether a distribution is necessary to satisfy a financial need
In assessing whether a hardship distribution would satisfy the financial need, the old regulations required participants to take any available plan loans before taking a hardship distribution. And once the distribution was made, the participant could make no deferrals for six months. The new hardship distribution rule eliminates these two rules with the hope that participants will be able to replace their account assets more quickly after the hardship distribution. Now, two simple requirements must be met:

1) A hardship distribution must not exceed a participant's need (including amounts to pay penalties and taxes).
2) The participant must not have any other way of meeting that need.

The *first* requirement is pretty straightforward. To meet this second requirement:

- Participants must first take all other available distributions from the plan and from all deferred compensation plans of the employer
- Participants must represent to the plan administrator that they have insufficient funds "reasonably available" to satisfy the financial need, and
- The plan administrator cannot have actual knowledge that the participant's representation is false

Modest changes to the “immediate and heavy financial need” safe harbor provisions

The final regulations added a seventh safe harbor reason for hardship distributions and made a couple of other minor changes.

Federal disaster declarations

The final regulations add a safe harbor for “expenses and losses—including loss of income—incurred by the employee” in FEMA-declared disasters. Employers may apply this safe harbor to distributions taken on or after January 1, 2018. This safe harbor expense differs from previous IRS disaster relief in that it applies only to the *participant’s* losses and expenses (not to the losses and expenses of the participant’s relatives or dependents). In addition, participants do not need to take a hardship distribution by a specific deadline for each disaster.

Repairing damage to principal residence

The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated an income tax deduction for certain personal casualty losses for tax years 2018 through 2025 unless the losses were part of a federally declared disaster. This change radically reduced the safe harbor that allowed for repair to a principal residence. The IRS removed the link to this tax deduction in the regulations, thus restoring the broad usefulness of this safe harbor.

Primary beneficiary safe harbor

This change aligns the regulations with an earlier law change that, plan permitting, includes the hardship of an employee’s *primary beneficiary* for medical, educational, or funeral expenses.

Employers may add other conditions, but can’t suspend deferrals

Beginning January 1, 2020, an employer cannot require participants in a qualified plan, 403(b) plan, or governmental 457(b) plan to suspend employee contributions after receiving a hardship distribution.

More contribution sources available for distributions

The new rules allow participants to take hardship distributions from more plan sources:

- Qualified nonelective contributions (QNECs)*
- Qualified matching contributions (QMACs)*
- Employer ADP safe harbor and QACA safe harbor contributions*
- Earnings on all of these amounts and on elective deferrals (earnings not allowed with any 403(b) plans)

*Not for 403(b)(7) custodial accounts

Applicability dates

The new hardship distribution rules apply to distributions taken on or after January 1, 2020, but employers may choose to apply the rules to distributions taken in plan years beginning after December 31, 2018.

Amendment deadlines

Employers will have to amend their plans to reflect the new hardship rules. Individually designed qualified retirement plans and 403(b) plans were given until December 31, 2021, to amend for the hardship distribution regulation. But preapproved plans were originally stuck with an earlier deadline based on long-established IRS procedures. The IRS provided oral guidance that promised some relief, but certain plans (on a noncalendar plan year) faced a pretty tight amendment time frame.

Fortunately, on December 12, 2019, the IRS issued Revenue Procedure 2020-09, which gives much-needed relief for preapproved plans. This guidance aligns the amendment deadline for preapproved qualified plans with the existing deadline for individually designed qualified plans and 403(b) plans. Accordingly, the amendment deadline for all of these plans is December 31, 2021. We will let you know about the amendment process as it develops.

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