

September 20, 2019

## IRS Finalizes Rules for Hardship Withdrawals

On September 19, 2019, the Internal Revenue Service (IRS) released final regulations for hardship withdrawals from 401(k) and 403(b) plans, addressing changes made by the Bipartisan Budget Act of 2018 (BBA 2018) and The Tax Cuts and Jobs Act of 2017 (TCJA 2017). These final regulations are substantially similar to the IRS proposed regulations which appeared in the November 14, 2018 issue of the *Federal Register*.

### Summary of the Legislative Changes to Hardship Withdrawal Rules

The final regulations provide guidance on the BBA 2018 changes to the hardship distribution rules:

- Elimination of the six-month suspension of elective deferrals and employee contributions following a hardship withdrawal and the requirement that all available plan loans be taken prior to a hardship distribution; and
- Ability for a hardship withdrawal from a 401(k) plan to include earnings on elective deferrals, QMAC and QNEC sources (as well as their respective related earnings).

In addition, TCJA 2017 provided that for taxable years 2018 through 2025, the deduction for casualty loss is generally only available to the extent that the loss is attributable to a federally declared disaster as defined under Internal Revenue Code (IRC) Section 165(h)(5).

The cross-reference to IRC Section 165 meant that (without further modification) hardship withdrawals due to casualty loss could only be attributable to a federally declared disaster during the 2018-2025 tax years. In recognition of the unanticipated consequences of that cross-reference, the IRS modified the safe harbor reasons for a hardship withdrawal by:

- Providing that expenses relating to damage to a principal residence could be considered a casualty loss without regard to the new limitations in IRC Section 165, as enacted by TCJA 2017 (i.e., the damage to the principal residence does not need to arise as part of a federally declared disaster); and
- Adding a new safe harbor reason that would allow a hardship distribution to cover losses and expenses incurred on account of a federally declared disaster designated as such by the Federal Emergency Management Agency (FEMA).

### Summary of the Final Hardship Regulations

The final hardship regulations provide additional clarification from the proposed regulations:

- A hardship withdrawal for disaster-related expenses:
  - Is available only to the employee who lived or worked in the disaster area. Expenses or losses of an employee's relative or dependent will not be considered eligible under this safe harbor event;
  - Is not subject to a specified deadline for a hardship distribution request related to the disaster-relief safe harbor; and
  - An employer may choose to add this disaster-relief safe harbor to the plan at a later date (for example, when such a disaster occurs), provided that the amendment to permit the disaster-relief safe harbor is adopted by the end of the plan year in which it is effective.

- The elimination of the six-month suspension of employee contributions following a hardship withdrawal applies to 401 qualified plans, 403(b) tax deferred annuity plans, and governmental 457(b) plans. An employer may decide, as a matter of plan design, to impose a suspension of employee contributions to other plan types (including a 457(b) plan sponsored by a nonprofit organization and a nonqualified plan under IRC Section 409A).
- The participant's representation to the plan administrator that he or she has insufficient cash or other liquid assets to satisfy the need:
  - Relates only to cash or liquid assets "reasonably available" to satisfy the need. For these purposes, all other available distributions under all the employer's plans includes any ESOP dividends;
  - Includes a verbal representation by the participant obtained via telephone on a recorded line;
  - Is assessed for veracity based on sufficiently accurate information that the plan administrator already possesses.
- The final hardship regulations confirm that the safe harbor requires the elimination of the suspension of a participant's elective deferrals and employee after-tax contributions to 401, 403(b) and governmental 457(b) plans of the employer for a period of six months following that participant's hardship withdrawal under a 401(k) or 403(b) plan, effective for hardship distributions taken on or after January 1, 2020.

Note that plans have the option to either terminate a participant's existing suspension when the suspension requirement for new hardship withdrawals is eliminated from the plan, or let the suspension run its course. For example, if the six-month suspension is removed from the plan beginning on January 1, 2020, for a participant who took a hardship withdrawal in the second half of 2019, the plan may be amended to either terminate the suspension as of January 1, 2020 or let it run its course.

- The safe harbor requirement to exhaust all nontaxable available plan loans is eliminated, effective for plan years beginning after December 31, 2018.
- Effective for plan years beginning after December 31, 2018, a 401(k) plan may – but is not required to – permit a hardship withdrawal to include earnings on elective deferrals.

Note: This feature does **not** apply to 403(b) plans. Because BBA 2018 did not amend IRC Section 403(b)(11), earnings attributable to elective deferrals under a 403(b) plan continue to be ineligible for a hardship withdrawal.

- Effective for plan years beginning after December 31, 2018, a 401(k) plan may – but is not required to – permit a hardship withdrawal to include employer contributions that are QNECs and QMACs (including those made under a safe harbor 401(k) plan) and earnings attributable to these contributions.

Note: These contribution sources may be available for hardship withdrawal under certain 403(b) plans, only if invested in an annuity contract, providing that the annuity contract permits such amounts to be withdrawn for hardship. Employer contributions held in a 403(b)(7) custodial account are not available for a hardship withdrawal under a 403(b) plan.

### **Effective Date of the Final Regulations**

The final hardship regulations are effective for hardship withdrawals made on or after January 1, 2020.

A plan sponsor may (i) apply the new safe harbor reasons for a hardship to hardship withdrawals made on or after January 1, 2018; and (ii) apply the elimination of the six-month suspension of employee contributions following a hardship withdrawal and/or make elective contributions, QNECs, QMACs, and/or safe harbor contributions described in 401(k)(13) (including any related earnings) eligible for hardship withdrawal as of the first day of the first plan year beginning after December 31, 2018.

## Plan Amendments

The IRS notes plan sponsors will need to amend the hardship provisions of their plan document.

- For individually designed, non-governmental plans, the applicable deadline will be the end of the second calendar year that begins after the issuance of the annual IRS Required Amendments List (RAL) that contains the hardship rule changes. If the final hardship regulations are included in the 2019 RAL, the deadline for individually designed plans would be December 31, 2021.
- For pre-approved plans other than 403(b) plans, the applicable deadline is the employer plan sponsor's tax filing deadline, plus extensions, for 2020.
- For pre-approved 403(b) plans, the IRS notes that while the remedial amendment deadline for restating a 403(b) plan to an IRS pre-approved 403(b) plan document is March 31, 2020, the Treasury Department and the IRS are considering providing for later amendment deadlines to be provided in separate guidance for 403(b) plan sponsors.

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