memorandum

HARDSHIP WITHDRAWALS AFTER 2017

There have been significant changes to the rules governing hardship withdrawals from 401(k) plans since 2017. This firm memorandum summarizes those rules, as well as actions that need to be taken if plan sponsors wish to adopt the changes. Our personal view is that plan sponsors should consider not adopting those changes that make it easier for participants to take hardship withdrawals from the plan.

Background

401(k) plans are permitted, but not required, to allow participants to make withdrawals from their accounts due to certain hardships. Congress modified these rules in 2017 and again in 2018 to liberalize (and restrict in some cases) some of those rules. The 2017 changes generally became effective in 2018 and the 2018 changes are generally effective in 2019, but there are exceptions.

Hardship withdrawals are permitted in the following circumstances:

1. The plan document expressly permits them,
2. The employee incurs an immediate and heavy financial need, and
3. The withdrawal does not exceed the amount necessary to satisfy the financial need.

Comment: The new rules do NOT change the existing rules that hardship withdrawals are an optional plan feature. Plan sponsors do NOT have to offer hardship withdrawals.

What Constitutes A Hardship

A hardship withdrawal can only be made if the employee has incurred an immediate and heavy financial need (item #2 above). Treasury regulations set out six safe harbor events that qualify. One of the safe harbor hardships is expenses for the repair of damage to the employee's principal residence that would qualify for a casualty deduction (determined without regard to the 10% of AGI limitation) under Section 165 of the Internal Revenue Code.

Example: A tree falls on the employee's personal residence. That qualifies but a tree falling on the employee's child's separate residence does not.

NOTE: The employee is not deemed to have an immediate and heavy need if the employee has readily available alternative sources of money. So, if the tree falls on the employee's personal residence and the entire loss is covered by insurance, no hardship withdrawal can be taken. The new rules do not change this.

The 2017 changes (effective in 2018) limited that to a casualty loss that occurs in a federally declared disaster. Example: A tree falls on the employee's personal residence. This no longer qualifies unless FEMA has declared his residence to be in a disaster area, like after a hurricane.

The 2018 changes expands the list of eligible casualty loss expenses to anything the employee loses as long as the employee's principal residence or place of employment is in a FEMA-declared disaster area. Example: Employee's fishing boat is parked at his home and is destroyed along with his house in a hurricane that FEMA declares to be a disaster area. Apparently he can take a hardship withdrawal to fix the boat, as well as his house.

The 2018 changes also allow a hardship withdrawal for the employee's primary beneficiary if the hardship is for medical, educational or funeral expenses. NOTE: The current rules permit hardship withdrawals for medical, educational and funeral expenses of the employee, spouse or dependents (and the employee's parent in the case of funeral expenses). The new rules expand this list to include the employee's primary beneficiary who may be somebody else such as a life partner.

The 2018 changes are effective between 2018 and the end of 2025.

<u>What Accounts Can Be Accessed</u>

A hardship withdrawal used to be limited to actual contributions to the employee's 401(k) contribution source account. Earnings on those contributions could not be accessed in a hardship withdrawal. Hardship withdrawals from safe harbor accounts were not allowed at all. Other accounts (such as rollover accounts and employer discretionary contribution accounts) could be available for a hardship withdrawal if the plan otherwise permitted them.

The 2018 changes expand the contribution sources from which a hardship withdrawal may be taken to any account the employee has in the plan. Plus, earnings in the account may also be accessed.

Comment: We caution employers about "opening the flood gates" on these hardship withdrawals. Congress wanted to be compassionate but 401(k) plans are intended to be retirement plans, not savings accounts for any qualifying hardship that comes along.

<u>Suspending 401(k) Contributions</u>

An employee must generally suspend 401(k) contributions for at least six months after taking a hardship withdrawal. The suspension period can be longer except in the case of a safe harbor 401(k) plan where the suspension cannot exceed six months.

The 2018 changes eliminate this suspension entirely. The 2018 changes also eliminate the need for the employee to take a plan loan before requesting a hardship withdrawal.

The 2018 changes are generally effective in 2019 but an employer can waive the suspension before 2019 if it chooses. Example: Sally Smith took a hardship withdrawal on October 1, 2018 and cannot resume 401(k) contributions until April 1, 2019. The plan may be amended to permit her to resume 401(k) contributions before April.

Comment: A plan can still impose a suspension period if it wants but only to January 1, 2020. After that suspensions are not even allowed.

<u>Substantiation Requirements</u>

A hardship withdrawal may only be granted "on account of an immediate and heavy financial need" and the withdrawal is needed to "satisfy the financial need." Under the current rules, whether the employee really needs the hardship withdrawal was based on all the relevant facts and circumstances. The new rules change this and impose a general standard to determining whether the distribution is needed. Under this new general standard, the withdrawal may not exceed the employee's need (including taxes on the withdrawal itself), the employee must exhaust his/her other available distributions under the plan, and the employee must represent he/she has no other source of money to pay the hardship. Beginning in 2020, the employee's representation must be in writing.

<u>Our Comments</u>

Congress seems to be sensitive to employees who have incurred hardship withdrawals as a result of natural disasters like hurricanes. Going forward, hardship withdrawals for casualty losses will be limited to FEMA-declared disaster areas. Most of our clients are in the northern Illinois / southern Wisconsin areas, so the new rules will restrict hardship withdrawals for casualty losses since we are not generally in FEMA-declared disaster areas.

The new rules expand the contribution sources from which hardship withdrawals may be taken and, in the case of 401(k) accounts, earnings in those accounts may also be accessed. We caution employers about expanding these sources, although permitting earnings from 401(k) accounts makes sense if the plan already permit hardship withdrawals from those accounts. We do recommend, however, that an employer limit any in-service withdrawal to accounts that are fully vested. There are tricky record keeping issues that arise where in-service withdrawals are taken from less than fully vested accounts. [Call us if you wish to discuss this more.]

Hardship withdrawals are something that the IRS likes to look at on audit. The Service seems to think it is an area that is ripe for abuse. Compounding this is that the IRS over the years has issued confusing and perhaps contradictory rules. In February 2017, the IRS issued an internal memorandum instructing their auditors on which documents to request when reviewing hardship withdrawals. The IRS offered two substantiation approaches. The first is to obtain documentation that the hardship is "immediate and heavy." This is the traditional approach and reflects the general process whereby the employee completes and returns paperwork requesting the withdrawal. The IRS memorandum, however, does not specify the documents the employee needs to furnish. Most of the fund companies we deal with require pretty clear substantiation, so we suspect this will not be a problem. The second approach is for the employee who submit a summary of the information contained in the source documents, but NOT the source documents themselves. Some fund companies use this approach, particularly where hardship withdrawals are requested online or via a call center. This alternative approach can be more problematic.

In our experience, employers do not want to immerse themselves in their employees' personal affairs, particularly in financial matters. Where hardship withdrawals are limited to 401(k) accounts only, most employers take the attitude "it is their money anyway." So employers have not been as insistent on actually obtaining source documentation. We think that for those employers who choose to expand the availability of hardship withdrawals, they should also tighten up on their substantiation requirements. We also think the fund companies may also tighten up their own general substantiation requirements.

Plan amendments will be required to implement these changes. So a sympathetic employer cannot just start using the new rules to the extent they are inconsistent with plan provisions. We strongly recommend an employer review their current plan documents and procedures before making any decisions about changes. For our clients, we suggest you contact your administrator at Dana Consulting to discuss this first.

On the subject of plan amendments, we expect some of the fully bundled providers will be sending out mass emails with canned amendments for plan sponsors to adopt if they wish to implement the changes. A plan sponsor will need to be sensitive to whether some action is required if the sponsor does NOT want to adopt all the changes. We would not be surprised if “default elections” will be to implement all the changes unless the plan sponsor notifies the document provider. An important point to keep in mind is that some plan features cannot be taken away once they are adopted. So if you fail to correctly respond to your document providers notice to you, you may be stuck with their default feature. Clients of our firm do not need to worry about this. We will discuss these changes with each client who may wish to consider adopting some or all of these changes before any amendments are actually adopted.

Please visit our website at www.danaconsulting.com for more information about the firms and their services. If you have any questions, please feel free to contact Lee T. Jennings at (630) 802-7644.

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