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401(k) PLANS

Implementing Recent Hardship Distribution Rule Changes from a TPA's Perspective

With the IRS memorandums from 2017, the Tax Cut and Jobs Act of 2018 (TCJA), and the Bipartisan Budget Act of 2018 (BBA), the requirements for hardship distributions have been updated for all parties involved. It is in the best interest of the plan for the plan sponsor to follow all necessary guidelines in order to take advantage of these changes.

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How We Are Accommodating the Hardship Distribution Changes Imposed by Recent Law Changes

This column is a follow-up to our column in the *Journal of Pension Benefits* Winter 2018 publication titled, "Does this Qualify as a Hardship Distribution? How Involved Should a TPA Be?"

In the previous column, we concluded it is in the best interest of the plan sponsor to follow all necessary hardship distribution guidelines to avoid a qualification issue. Based on the Internal Revenue Service (IRS) hardship distribution memorandums it seems prudent for the plan sponsor to provide a summary to participants requesting a hardship distribution and request

those participants to certify and retain all appropriate source documentation.

By following these new guidelines it seems the IRS agent only will request source documents (with their manager's approval) if a participant took at least two hardships during the year and the plan sponsor cannot provide sufficient reasons for more than one withdrawal. A paternalistic plan sponsor could collect the source document(s), however, the responsibility to evaluate the distribution then falls on the plan sponsor. If not properly substantiated, a qualification issue could occur if the IRS agent doesn't agree with the plan sponsor's decision to approve the distribution.

In order for the examiners to determine if one of the hardship distribution reasons (medical expenses, purchase of a principal residence, eligible tuition costs, prevent eviction/foreclosure from/of principal residence, certain funeral expenses, certain repairs to principal residence) applies, they are instructed to confirm if the participant provided either source documents (estimates, contracts, bills and statements) or a summary of the information contained in the source documents. If summary information was provided but was not complete, the examiner can request the source documents. If the summary information appears complete, the examiner will then review the summary.

The conclusion we reached in our previous column led us to create a supplemental hardship distribution application for plan sponsors to have participants complete along with the hardship distribution form from the record-keeper/TPA in order to request a hardship distribution. We provide a copy of the supplemental application, including the updates we made to the form for 2019 (*see* Exhibit 1 at end of column).

The Hardship Distribution Application (HDA) we created is completed in addition to the actual hardship withdrawal form, whether it is a vendor-provided form or our own distribution form. The primary purpose of the distribution form is to have the hardship distribution request processed, whereas the HDA is designed only to avoid having the participant provide copies of financial information, medical bills, etc., to the plan sponsor, who, in turn, had to try to determine if the documentation properly supported the hardship distribution request. Therefore the two documents work together to request and support a hardship distribution. Our HDA is based on guidance provided by the IRS and allows the plan sponsor to consider the request as reasonable once certain guidelines are followed. The participant is responsible for maintaining the source documentation and the plan sponsor can

rely on the details provided without receiving copies of that source information.

Our HDA consists of two parts. The first page is the application followed by an attachment. The attachment is a series of in-depth questions intended to generate a summary description of the hardship from the participant in lieu of actual source documents. The full application is to be completed by the participant and returned to the plan sponsor for its review. Once the full application is complete, the plan sponsor can approve the application based on the summary documentation. The sponsor returns only the first page of the HDA and the applicable hardship distribution paperwork to our office for processing.

The HDA includes the general information required by the IRS: participant's name, total cost of the hardship event, amount of distribution requested, and certification by the participant that the information provided is true and accurate. The HDA also includes the following required notifications to the participant who requests the hardship distribution:

1. The hardship distribution is taxable and additional taxes could apply;
2. The amount of the distribution cannot exceed the immediate and heavy financial need; and
3. The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.

The attachment portion of the HDA includes the detailed checklist of required information for each hardship event, with the participant completing the section applicable to its situation, thereby providing the plan sponsor with the following required details:

1. Total cost of the event causing hardship (for example, total cost of medical care, total cost of funeral/burial expenses, payment needed to avoid foreclosure or eviction);
2. Amount of distribution requested; and
3. Certification by the participant that the information provided is true and accurate.

If the plan is at a vendor (*e.g.*, Empower or American Funds Plan Premier) where the participant works directly with the platform to request the distribution, we work with the plan sponsor to have the full HDA completed and returned to the plan sponsor. While we only request to have the first page of the HDA returned to us, we ask the plan sponsor to retain the entire application for its plan records.

Bipartisan Budget Act of 2018

The Bipartisan Budget Act of 2018 (BBA) significantly changes the administration for hardship distributions for Section 401(k) and Section 403(b) plans.

The six-month suspension of elective deferral contributions following a hardship distribution is being removed from the Treasury Regulations. This change is required for hardship distributions made on or after January 1, 2020. In line with our document providers we have made this change effective with all hardship distributions taken on or after January 1, 2019.

In addition, distributions no longer fail to qualify for the safe harbor hardship distribution rules because a participant does not first take all available loans under this plan and other plans maintained by the employer. This helps streamline the hardship distribution process as participants are no longer required to prove that the loan payments would impose a hardship in and of themselves in order to be eligible to take a hardship distribution.

The BBA also expanded the portion of the participant's 401(k) account available for a hardship distribution to include qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), and the earnings on the elective deferrals. This includes safe harbor matches and safe harbor nonelective contributions in a safe harbor 401(k) plan. Again, in line with our document providers we have made this change for allowing hardship distributions from the earnings on deferrals effective with all hardship distributions taken on or after January 1, 2019. We feel that expanding hardship distribution options to sources beyond earnings on deferrals is a discussion to have with the plan sponsor as the Section 401(k) plan is a vehicle for retirement savings and the benefits therein should be preserved. If a plan sponsor is interested in expanding the portion of a participant's account that is available to take as a hardship distribution, we will discuss the options with them and amend the plan accordingly.

It is unclear if this was an oversight or not but it is important to note that the portion of the participant's

account available for hardship distribution that has been expanded to include the earnings on the elective deferrals does not apply to 403(b) plans. It also is important to note that QNECs and QMACs in a custodial account of a Section 403(b) plan are still not an eligible source for hardship distributions.

Safe Harbor Hardship Expenses

The proposed regulations add a new category of safe harbor hardship expenses for losses (including loss of income) incurred as a result of a federally declared disaster. To qualify for such a hardship distribution the participant's principal residence or place of employment must be located in the designated disaster area at the time of the disaster. This change is similar to the relief often granted by the IRS after a hurricane, wildfire, or flooding disaster and is intended to facilitate a participant's access to their account following such a disaster.

The proposed regulations also incorporate the guidance provided by the Pension Protection Act of 2006 and Notice 2007-07 by providing that qualifying medical, educational, and funeral expenses relating to a participant's primary beneficiary may qualify as expenses eligible for a hardship withdrawal.

Conclusion

We recommend that all vendors incorporate the recent and ongoing changes to hardship distributions to protect the plan sponsor from being found negligent in providing hardship distributions to the plan participants, while at the same time making it easier for participants to obtain a hardship distribution from the plan and for plan sponsors to approve those hardship distributions when necessary.

The changes have been positive for all involved. There is less of a burden on the plan sponsor to determine what qualifies as a hardship. Record-keepers and TPAs no longer need to track employees' contributions and earnings basis for hardship purposes. Plan sponsors no longer need to suspend a participant's deferrals and remember to restart them after six months. Participants can continue to save for retirement, having their immediate financial need met by taking the distribution. ■

Exhibit 1—Hardship Distribution Application

Plan Name: _____

Participant Name: _____ SSN: _____

As a participant in the above-named plan who is applying for a hardship distribution, I confirm that the reason for the hardship is: *(Check one and provide details in the applicable section of the attachment.)*

- A. ☐ Medical Care expenses incurred by me, my spouse, my dependents or my primary beneficiary.*
- B. ☐ Purchase of my principal residence.
- C. ☐ Education payments for the next 12 months of post-secondary education for me, my spouse, my child, my dependents, or my primary beneficiary.*
- D. ☐ Preventing foreclosure on my principal residence or eviction from my principal residence.
- E. ☐ Payments for burial and funeral expenses for my deceased parent, my spouse, my dependent, or my primary beneficiary.*
- F. ☐ Expenses for the repair of damage to my principal residence that would qualify as a casualty deduction under Internal Revenue Code Section 165 (determined without regard to Code Section 165(h)(5) or to whether the loss exceeds 10 percent of adjusted gross income).
- G. ☐ Expenses and losses (including loss of income) incurred by me on account of a disaster declared. **For hardship distributions during the period from 2018 through 2025, the principal residence or principal place of employment must be located in a federally declared disaster area. (Proposed option provided under BBA)**

I agree that in order to receive the hardship distribution requested above:

1. I understand hardship distributions are subject to income taxes (unless they consist of Roth contributions). I understand additional taxes, such as a 10 percent penalty tax on early distributions, may apply. I will consult a tax advisor with any questions.
2. The amount of the distribution cannot exceed my immediate and heavy financial need. I agree to preserve source documents and make them available at any time, upon request, to the employer.
3. I have provided the Specific Information on Deemed Hardships on the next page for the corresponding hardship distribution reason I indicated above.

TOTAL COST OF EVENT CHECKED ABOVE: \$ _____

AMOUNT OF HARDSHIP DISTRIBUTION REQUESTED: \$ _____

PARTICIPANT: I certify that the information provided above and on the attachment is true and accurate.

X _____ Date: _____

PLAN SPONSOR: I have reviewed the answers on the attachment and confirm that the request meets the requirements. I will keep the completed application and attachment for plan records.

X _____ Date: _____

Attachment to Hardship Application

Specific Information on Deemed Hardships: Complete the section that applies to your request and return the completed form to your employer to be kept with its records. This information will only be retained by your employer, it will not be provided to parties for processing.

A. MEDICAL CARE

1. Who incurred the medical expenses (name)? _____

2. What is the relationship to the plan participant?

Check one: ☐ self ☐ spouse ☐ dependent ☐ primary beneficiary*

3. What was the purpose of the medical care (not the actual condition but the general category of expense, for example, diagnosis, treatment, prevention, associated transportation, long-term care)?

4. Name and address of the service provider (hospital, doctor/dentist/chiropractor/other, pharmacy):

5. Amount of medical expenses not covered by insurance: _____

B. PURCHASE OF PRINCIPAL RESIDENCE

1. This will be the participant's principal residence ☐ Yes

2. Address of the residence:

3. Purchase price of the principal residence: _____

4. Types of costs and expenses covered:

Check all that apply: ☐ down-payment ☐ closing costs ☐ title fees

5. Name and address of the lender:

6. Date of the purchase/sale agreement: _____

7. Expected date of closing: _____

C. EDUCATION PAYMENTS

1. Who are the educational payments for (name)? _____

2. What is the relationship to the plan participant?

Check one: ☐ self ☐ spouse ☐ dependent ☐ primary beneficiary*

3. Name and address of the educational institution:

4. Categories of educational payments involved:

Check all that apply: ☐ post-high school tuition ☐ related fees ☐ room and board

5. Period covered by the educational payments (beginning/end dates of up to 12 months):

D. FORECLOSURE/EVICTION FROM PRINCIPAL RESIDENCE

1. This is the participant's principal residence ☐ Yes

2. Address of the residence:

3. Type of event (check one): ☐ Foreclosure ☐ Eviction

4. Name and address of the party that issued the foreclosure or eviction notice:

5. Date of the notice of foreclosure or eviction: _____

6. Due date of the payment to avoid foreclosure or eviction: _____

E. FUNERAL AND BURIAL EXPENSES

1. What is the name of the deceased? _____

2. What is the relationship to the plan participant?

Check one: ☐ self ☐ spouse ☐ dependent ☐ primary beneficiary*

3. Date of death: _____

4. Name and address of the service provider (cemetery, funeral home, etc.):

F. REPAIRS FOR DAMAGE TO PRINCIPAL RESIDENCE

1. This is the participant's principal residence ☐ Yes

2. Address of the residence that sustained damage:

3. Briefly describe the cause of the casualty loss (fire, flooding, type of weather-related damage, etc.):

4. Date of casualty loss: _____

5. Briefly describe the repairs, including the date(s) of repair (in process or completed):

G. FEDERALLY DECLARED DISASTER *(Proposed option provided under BBA)*

1. Address of the employee's principal residence:

2. Address of the employee's principal place of employment:

3. Briefly describe the expense or loss (loss of income, fire, flooding, type of weather-related damage, etc.):

4. Date of expense or loss: _____

* refers to proposed language from BBA

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