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Proposed IRS Regs Liberalize Rules for Hardship Withdrawals

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How hard should a hardship be to justify a hardship withdrawal from a 401(k) plan? There are more rules than you might think. However, proposed IRS regulations could, according to the agency itself, enable eligible plan participants “to access their money more quickly with a minimum of red tape.” Below is a short summary of several key provisions of the detailed proposed regulations.

The Status Quo

To provide context for the proposed (and highly likely) changes, here’s where things currently stand. These are — and continue to be under the proposed regulations — the most accommodating rules you can require participants to follow; you also can be more restrictive.

IRS rules require that hardship distributions be because of an “immediate and heavy need,” “limited to the amount necessary to satisfy that financial need,” and the participant can’t “reasonably obtain the [required] funds from another source.” Plan sponsors are required to review “all relevant facts and circumstances” before agreeing to permit a hardship withdrawal.

The rules, however, provide several safe harbors under which plan sponsors don’t need to make a judgment call. These involve:

- Medical expenses for the participant or the participant’s family members,
- Costs directly related to the purchase of a principal residence (excluding mortgage payments),
- Tuition, related educational fees, and room and board expenses for the next 12 months of postsecondary education for the participant or the participant’s family members,
- Payments to prevent eviction from a primary residence,
- Certain kinds of repairs to a damaged primary residence, and
- Funeral expenses for the participant or a family member.

The 2018 Bipartisan Budget Act’s proposed regulations include these same safe harbors and added several new categories, including expenses stemming from a federally declared disaster, such as a major hurricane, and medical, educational and funeral expenses for a beneficiary that isn’t a dependent.

3 Key Changes

The proposed regulations make three key changes to hardship withdrawal eligibility, each of which is seen as liberalizing their availability:

1. Relief from other sources. Before taking a hardship withdrawal, participants will no longer be required to show they have borrowed all that they can using available plan loans.
2. Source of distributions from plan contributions and earnings. Participants can draw hardship distributions from qualified nonelective contributions, qualified matching contributions, employer safe harbor contributions and earnings on those contributions, and earnings on regular 401(k) plan contributions.
3. No waiting period to resume contributions. Effective January 1, 2020, plan sponsors will no longer be able to require a participant who has taken a hardship withdrawal to wait six months before resuming plan contributions. Unlike the first two, this change isn’t optional, assuming you have a hardship withdrawal provision in the first place.

These changes are intended to become effective retroactively to January 1, 2019, but could be subject to some fine-tuning in the regulations’ final version.

Sponsor Duties

Beginning in 2020, plan sponsors would also be able to take advantage of a liberalized standard for policing participant compliance with eligibility requirements for hardship withdrawals. Specifically, participants would need only “represent, in writing, by an electronic medium … that he or she has insufficient cash or other liquid assets to satisfy his or her hardship need” unless the plan sponsor or plan administrator “has actual knowledge to the contrary.”

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What is “actual knowledge to the contrary”? For example, suppose a plan sponsor happens to learn or hear something that suggests that a participant isn’t as financially challenged as he or she has told you, or the participant recently received a bonus award. Would that represent “knowledge” on the plan sponsor’s part, or only evidence for speculation about the participant’s financial position? It’s unclear at this time and just one concern if plan sponsors decide to retain hardship withdrawals in light of the proposed regulations.

Food for Thought

The proposed regulations might prompt you to rethink your current policy on hardship withdrawals. Remember, plans aren’t obligated to allow hardship withdrawals, and they can be a headache to administer. Look for the final version of the regulations later this year.

How Should You Respond to the Changes?

Employers could make one of several moves in response to the proposed IRS regulations on hardship withdrawals. (See main article.) Other than dropping the six-month postwithdrawal contribution resumption restriction, plan sponsors could:

- Ignore the rest of the changes made by the proposed regulations,
- Make their plans’ hardship withdrawal requirements more stringent, or
- Stop allowing hardship distributions altogether.

Plan sponsors might eliminate hardship withdrawals when they believe participants who use that option are doing themselves more financial harm than good. Statistics show that leakage from plans is a significant issue as participants deplete their retirement savings. Liberalizing hardship rules may further exacerbate leakage in the future.

Hardship withdrawals are typically taken by relatively young participants who tend to wait longer to resume contributing to their accounts. According to the Employee Benefit Research Institute, the lowest income quartile of participants who take a hardship distribution and wait two years before resuming deferrals take a 25% hit on their ultimate retirement savings accumulations when they stop working.

Still, it’s unusual for a retirement plan not to allow hardship withdrawals. Sponsors who worry about the long-term impact of such distributions can take other steps to minimize them, including limiting the size of distributions and allowable reasons. For example, a plan sponsor might decide that the financial burden of a home purchase or college tuition payment doesn’t qualify as a hardship distribution under its plan.

Create a communication program tailored to participants who take (or are considering taking) hardship withdrawals. Then, default those who do into promptly resuming their deferrals, if they suspend them following a hardship withdrawal.

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