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Frequently Asked Questions Concerning 401(k) Plan Hardship Distributions

1. Why am I receiving these frequently asked questions (FAQs) concerning 401(k) plan hardship distributions?

Your 401(k) plan allows participants to request a distribution on account of the participant's hardship. Congress and the Internal Revenue Service (IRS) have recently made significant changes in the rules governing hardship distributions under 401(k) plans. These changes generally become operationally effective January 1, 2020, although employers can elect earlier implementation. Even without regard to these changes, the rules governing hardship distributions are sometimes poorly understood by plan sponsors and participants. These FAQs are intended to help you understand these rules, including the recent changes.

2. How does a 401(k) plan participant qualify for a hardship distribution?

To qualify for a hardship distribution, a participant must meet two conditions:

- the participant must have an <u>immediate and heavy financial need</u> and
- the distribution must be limited to the <u>amount necessary</u> to satisfy that financial need.

3. What constitutes an immediate and heavy financial need?

Virtually all D&M plans use the regulatory "safe harbor" definition of immediate and heavy financial need, which includes any of the following:

- medical care expenses previously incurred for the participant or the participant's spouse or dependents;
- costs directly related to purchase of the participant's principal residence (excluding mortgage payments);
- tuition, related educational fees and room and board expenses for the next 12 months of post-secondary education (i.e., the individual must have a high school diploma) for the participant or the participant's spouse or dependents;
- payments necessary to prevent eviction from the participant's principal residence or foreclosure on the mortgage on that residence;

- burial or funeral expenses for the participant's deceased parent, spouse, children or dependents;
- casualty loss to the participant's principal residence; or
- expenses and losses (including loss of income) incurred by the participant on account of a federally-declared disaster.

4. What if my employee has a serious financial need that is outside of these seven events? Can this constitute an immediate and heavy financial need eligible for a hardship distribution?

If your plan uses the regulatory safe harbor definition of immediate and heavy financial need, then the answer is no. For example, payments necessary to repair a participant's automobile generally would not qualify for a hardship distribution, even if the participant needs the automobile to get to work and earn a living.

5. When is an amount necessary to satisfy such need?

A distribution is treated as necessary to satisfy an immediate and heavy financial need if all of the following three requirements are met:

- the distribution does not exceed the amount of a participant's need;
- the participant has obtained all other currently available distributions, other than hardship distributions and loans, under the plan and all other plans of deferred compensation (whether qualified or nonqualified) maintained by the employer; and
- the participant represents that he or she has insufficient cash or other liquid assets reasonably available to satisfy the need, and the plan administrator does not have actual knowledge to the contrary.

6. How does this new standard differ from the previous standard?

The new standard eliminates the following conditions:

- the participant has maxed out on plan loans, and
- the participant's contributions to the employer's plans are suspended for six months.

7. Can my plan impose additional conditions to obtain a hardship distribution?

Generally, yes. However, after 2019, plans are not allowed to impose a suspension of participant contributions as a condition to receiving a hardship distribution.

8. How must a participant substantiate his or her hardship request?

Employers have two options for confirming that a participant's distribution request satisfies the hardship requirements:

a. Obtain copies of relevant backup documentation (e.g., estimates, contracts, bills or statements from third parties) from the participant, and retain such copies with the plan's records.

   We recommend that employers who self-administer their plans' hardship distribution program take this approach.

b. Obtain from the participant a summary of certain information concerning the hardship. Under this approach, the employer must provide certain information to the participant and obtain certain information from the participant.

   We recommend that your plan take this approach only if your plan uses an investment platform to administer its hardship distribution program. These platforms often allow participants to electronically "self-certify" their hardship.

In all cases, there should be a written or electronic record of the hardship request, review and approval and proof of the actual distribution and related Form 1099.

9. What sources of plan money are available for hardship distributions?

In addition to 401(k) elective deferrals, the new rules allow hardship distributions from safe harbor employer contributions, qualified non-elective employer contributions (QNECs), qualified matching contributions (QMACs), and earnings on all of the foregoing. Implementing this expansion of sources for hardship distributions is optional.

10. When do the new hardship rules take effect?

The new hardship rules must be implemented beginning no later than January 1, 2020. However, employers may elect to implement the new rules during 2019.

Since the new rules will become effective January 1, 2020 and may be applied earlier, we recommend that you make operational decisions to implement the new rules as soon as possible, if you haven't already done so. These operational decisions will need to be implemented before your plan document is formally amended, as described in the next two FAQs.

11. How do I implement the new hardship rules?

In the last part of 2018, we sent to all of our 401(k) plan clients a Hardship Distribution Operational Checklist to assist them in making operational decisions concerning the new rules. We also suggested certain "default" operational rules for our clients' hardship provisions.

The new rules must be implemented no later than January 1, 2020. To assist you in implementing the new hardship rules, we are including with these FAQs:

- a completed Hardship Distribution Operational Checklist that adopts the default hardship distribution alternatives, and

- a participant communication, entitled "Summary of Changes in Retirement Plan Hardship Distribution Rules", describing the changes in the hardship distribution rules for your plan that reflects the default Hardship Distribution Operational Checklist.

Please review the default Hardship Distribution Operational Checklist to make sure that the default rules work for you. If so, please execute the checklist in the space provided at the end of the checklist and retain the executed checklist with your plan records. You should also distribute to plan participants the communication describing the changes in the hardship distribution rules for your plan.

Please contact your D&M plan consultant if do not want to adopt the default hardship selections.

12. When will my plan need to be amended to reflect the new hardship rules?

All affected plans prepared by D&M use a pre-approved prototype plan document. These plans will need to be amended to reflect the new hardship rules effective for distributions beginning no later than January 1, 2020.

For calendar year plan sponsors, the deadline for adopting this amendment will generally be March 15, 2021, or September 15, 2021 if filing of the plan sponsor's 2020 tax return is extended. However, the final rules are not completely clear on this amendment deadline, and practitioners will be requesting clarification from IRS. We will let you know if the deadline changes.

13. The hardship rules have become too complicated. Can I amend my plan to eliminate the hardship distribution option?

Yes, a plan can be amended at any time to eliminate, or modify the conditions for, hardship distributions. However, you will want to consider possible employee participation and relations issues arising from elimination or curtailment of hardship distributions under your plan. Logically, an employee may be more likely to make

401(k) elective deferrals if the employee knows that those funds can be accessed in the event of a hardship.

14. What if I still have questions after I've read these FAQs?

If you still have questions about the hardship distribution rules, please feel free to contact your D&M plan consultant. That's what we're here for.