

Final 401(k) Regulations – Part Five
June 23, 2005

The final 401(k) regulations make some interesting changes in plan distributions. For example, there are two new safe harbor reasons for allowing hardship distributions.

Hardship and the 401(k) Final Regs.

Deferred Profit-Sharing Plans, [i.e. 401(k) Plans], have the option to contain special provisions which allow in-service distributions before the attainment of age 59½ for employee pre-tax contributions, if the participant can demonstrate financial hardship. The rules for hardship withdrawals vary based on whether or not the plan uses the so-called “safe harbor” rules or the general facts and circumstances test. Hardship withdrawals are only available when the employee has an immediate and heavy financial need that cannot be satisfied by other resources of the participant. There are limits on which dollars and how much money may be withdrawn.

General Rules

A distribution is considered to be on account of hardship if the distribution is necessary to relieve an *immediate and heavy financial need* of the employee and other resources are not reasonably available to satisfy the need. A distribution based upon financial hardship cannot exceed the amount required to meet the immediate financial need created by the hardship. Such amount may, however, be increased as required to fund the income tax due on the amounts received. As of January 1, 2002, all sources of hardship funds are ineligible for rollover, thus withholding is voluntary.

Plan Must Define Reason for Hardship

Prototypes plan documents are currently required to adopt the following 4 specific deemed reasons for hardship, also known as safe harbor hardship reasons:

1. Medical expenses described under Code §213(d) incurred or anticipated to be incurred by the employee, the employee's spouse or dependent. This is for all deductible medical expenses -- not just the amounts that actually exceed 7.5% of adjusted gross income.
2. Purchase (excluding mortgage payments) of a principal residence of the employee.
3. Tuition and related educational fees for the next 12 months for post-secondary education for the employee, spouse, children or dependents.
4. Payment to prevent eviction from the employee's primary residence or foreclosure on the mortgage on the employee's primary residence.

The recently issued final 401(k) Regulations that become effective for Plan Years that begin after December 31, 2005 add two additional hardship reasons. (The final 401(k) regulations may be implemented at any time after December 29, 2004, provided that *all* of the final regulations, not just the hardship rules, are implemented.) The expanded safe harbor deemed acceptable distribution list will now also include:

- Funeral expenses of parents, spouse, children or dependents.
- Certain expenses relating to the repair of damage to the employee's principal residence that would qualify for the casualty deduction, such as those resulting from hurricane or flood damage (determined without regard to whether the loss exceeds 10% of adjusted gross income). [Code Section 165](#).

Hardship Administrative Compliance Notes:

- a. The Regulations require that the participant first take a plan loan before receiving a hardship withdrawal. However, that requirement may be avoided if it results in making the hardship worse.
- b. Dependent Definition
- c. Although the specific content of hardship documentation is not addressed, plan participants are reminded that they are required to keep records to demonstrate compliance.
 - i. Medical, funeral, and post-secondary education expenses incurred for a spouse, child or dependent are eligible without regard to the definition of dependent under the Working Families Tax Relief Act of 2004.
 - ii. Eligible medical expenses also include those incurred for a non-custodial child who is subject to section 152(e) (special rules for divorced parents), but would exclude nonprescription drugs or medicine (other than insulin).

Administrative Requirements

The plan administrator must make a determination that an immediate and heavy financial need exists, and must determine whether the participant has reasonably available resources to satisfy such need. For this purpose, the plan sponsor may rely upon the representations of the employee regarding all relevant facts and circumstances pertaining to the withdrawal. Under the safe-harbor rules, the employees deemed to have a hardship if they can show a need based upon one of the six reasons specified above. The withdrawal documentation must also contain/show:

1. That the employee has obtained all other available distributions (after-tax contributions and employer contributions if otherwise available for withdrawal) and loans from other employer plans, *provided* the addition any additional loan repayments will not make the hardship worse.
2. That the plan using the safe harbor provisions requires a mandatory suspension of employee contributions to the plan and **all** other qualified and nonqualified plans maintained the employer. As of 2002, the minimum period of suspension was reduced from 12 to 6 months.

Document

The final 401(k) regulations are available for plan years that begin after December 31, 2005. In order to implement the new hardship rules, they need to be added to the plan document by amendment. We are currently awaiting IRS guidance regarding how to incorporate the final 401(k) regulations into the current GUST document for plan years beginning after December 31,

2005. The forthcoming EGTRRA document will contain the final 401(k) regulation changes; however, that document will not be available for use for at least two years.

Difference in Hardship Rules for Pre-Approved Plans Versus Individually Designed Plans

So far we have described the way hardship withdrawals are accomplished in a prototype plan.

An individually designed plan may use the facts and circumstances method for determining a hardship, which places a much larger burden on the employer to verify that there is an immediate and heavy financial need that satisfies the IRS hardship rules and examine the participant's available resources.

As indicated earlier, plans using the safe harbor or deemed hardship rules are required to have suspension of elective deferral; however, individually designed plans that use the facts and circumstances test are not necessarily required to have a suspension.

Prototype plans generally must use only the deemed rules and thus must have the suspension.

There is also a difference in the requirement to exhaust all other funds before taking a hardship distribution. Individually designed plans require the participant to take all other funds available, including a loan from a commercial lender, unless the commercial loan is not issued in an amount sufficient to meet the hardship.

For both the facts and circumstances and the deemed safe harbor method, a plan loan must be taken before a hardship is to be done, unless the loan increases the participant's hardship.

Note: Volume submitter plans depending on the provisions of the plan may follow the safe harbor rules or may choose the facts and circumstances method of determining hardship or a combination thereof.

Regulations

We present the hardship provisions from the 401(k) final regulations. We have rewritten them just a bit for easier reading. They appear below. Please note that there are three examples at the end of the regulatory material. Example 3 uses the deemed method and takes a limited approach to examining additional assets, while Example 2, represents a plan using the facts and circumstances method.

Final 401(k) Regulations Section 1.401(k)-1(d)(3) Hardship Rules

Rules applicable to hardship distributions —

(i) Distribution must be on account of hardship.

A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy

financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

(ii) Limit on maximum distributable amount —

(A) **General rule . The maximum distributable hardship amount is the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions.** Thus, the maximum distributable amount does not include earnings, QNECs or QMACs(unless grandfathered under next paragraph).

(B) **Grandfathered amounts .** If the plan so provides, the maximum distributable amount may be increased for amounts credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or in the case of a collectively bargained plan, the earlier of—

(1) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements in effect on March 1, 1986, terminates (determined without regard to any extension thereof after February 28, 1986); or

(2) January 1, 1991, and consisting of income allocable to elective contributions; Qualified nonelective contributions and allocable income; and Qualified matching contributions and allocable income.

(iii) Immediate and heavy financial need —

(A) **In general .** Whether an employee has an immediate and heavy financial need is to be determined based on all the relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) **Deemed immediate and heavy financial need .** A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for—

(1) **Expenses for (or necessary to obtain) medical care that would be deductible under section 213(a)** (determined without regard to whether the expenses exceed 7.5% of adjusted gross income);

(2) **Costs directly related to the purchase of a principal residence for the employee** (excluding mortgage payments);

(3) **Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents** (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1) (individuals

who are dependents of a taxpayer), (b)(2) (married dependents) and (d)(1)(B) (dependents with income in excess of the exemption amount);

(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(d)(1)(B) (dependents with income in excess of the exemption amount)); or

(6) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

(iv) Distribution necessary to satisfy financial need —

(A) Distribution may not exceed amount of need.

- A distribution is treated as necessary to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the distribution is not in excess of the amount required to satisfy the financial need.

- The amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(B) No alternative means available.

- A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee.

- This determination generally is to be made on the basis of all the relevant facts and circumstances.

- For these purposes, the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee.

- Thus, for example, a vacation home owned by the employee and the employee's spouse, whether held as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee.

- However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee.

(C) Employer reliance on employee representation.

- For purposes of this section, an immediate and heavy financial need generally may be treated as not capable of being relieved from other resources that are reasonably available to the employee, if the employer relies upon the employee's representation (made in writing or such other form as may be prescribed by the Commissioner [of Internal Revenue]), unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved by:

- (1) Through reimbursement or compensation by insurance or otherwise;

- (2) By liquidation of the employee's assets;

- (3) By cessation of elective contributions or employee contributions under the plan;

- (4) By other currently available distributions (including distribution of ESOP dividends under section 404(k)) and nontaxable (at the time of the loan) loans, under plans maintained by the employer or by any other employer; or

- (5) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(D) *Employee need not take counterproductive actions.*

- For these purposes, a need cannot reasonably be relieved by one of the actions described above if the effect would be to increase the amount of the need. For example, the requirement to take a loan is superseded if such loan would disqualify the employee from obtaining other necessary financing.

(E) *Distribution deemed necessary to satisfy immediate and heavy financial need.*

- A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if each of the following requirements are satisfied—

- (1) The employee has obtained all other currently available distributions (including distribution of ESOP dividends under section 404(k), but not hardship distributions) and nontaxable (at the time of the loan) loans, under the plan and all other plans maintained by the employer; and

- (2) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

(F) *Definition of other plans.*

- The phrase plans maintained by the employer means all qualified and nonqualified plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. In addition, this classification also includes a stock option, stock purchase, or similar plan maintained by the employer. (See §1.401(k)-6 for the continued treatment of suspended employees as eligible employees.)

- However, the 6-month suspension of contributions does not apply to the mandatory employee contribution portion of a defined benefit plan or to a health or welfare benefit plan (including one that is part of a cafeteria plan).

(v) **Commissioner may expand standards** . The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin , expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need.

Hardship Examples

Example 1.

Fact Set

Employer Q maintains a single benefit plan (Plan Y).

Plan Y is a 401(k) plan that does not permit participant loans but contains safe harbor hardship withdrawal provisions regarding distributions necessary to satisfy financial need.

Employee A is an eligible employee in Plan Y with an account balance of \$50,000 attributable to elective contributions.

The total amount of elective contributions made by Employee A, who has not previously received a distribution from Plan Y, is \$20,000.

Employee A requests a \$15,000 hardship distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent.

At the time of the distribution request, the sole asset of Employee A that is reasonably available to Employee A is a savings account with an available balance of \$10,000.

Hardship Decision

A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. A distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependent is deemed to be on account of an immediate and heavy financial need of Employee A.

A distribution is treated as necessary to satisfy Employee A's immediate and heavy financial need to the extent the need may not be relieved from other resources reasonably available to Employee A. Employee A's \$10,000 savings account is a resource that is reasonably available to the employee and must be taken into account in determining the amount necessary to satisfy Employee A's immediate and heavy financial need. Thus, Employee A may receive a distribution of only \$5,000 of his elective contributions on account of this hardship, plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 2.

Fact set

The facts are the same as in Example 1.

Employee B, another employee of Employer Q has an account balance of \$25,000, attributable to Employee B's elective contributions.

The total amount of elective contributions made by Employee B, who has not previously received a distribution from Plan Y, is \$15,000. Employee B requests a \$10,000 distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his child. Employee B makes a written representation (with respect to which Employer Q has no actual knowledge to the contrary) that the need cannot reasonably be relieved:

- (A) Through reimbursement or compensation by insurance or otherwise;
- (B) By liquidation of the employee's assets;
- (C) By cessation of elective contributions or employee contributions under the plan;
- (D) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or
- (E) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

Hardship Decision

A distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee B's child is deemed to be on account of an Employee B's immediate and heavy financial need.

In addition, because Employer Q can rely on Employee B's written representation, the distribution is considered necessary to satisfy Employee B's immediate and heavy financial need. Therefore, Employee B may receive a \$10,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 3 .

Fact Set

The facts are the same as in Example 1, except Plan Y provides for hardship distributions using the deemed hardship distribution rule.

Accordingly, Plan Y provides for a 6 month suspension of an eligible employee's elective contributions and employee contributions to the plan after the receipt of a hardship distribution by such eligible employee.

Hardship Decision

A distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependent is deemed to be on account of an Employee A's immediate and heavy financial need. In addition, because Employee A is not eligible for any other distribution or loan from Plan Y and Plan Y suspends Employee A's elective contributions and employee contributions following receipt of the hardship distribution, the distribution will be deemed necessary to satisfy Employee A's immediate and heavy financial need (and Employee A is not required to first liquidate his savings account). Therefore, Employee A may receive a \$15,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.