

401(k) Hardship Distributions Likely to Take on Increased Importance During the COVID-19 Pandemic

In light of the COVID-19 pandemic and the resulting economic uncertainty, 401(k) plan sponsors can expect to see a significant increase in employee requests to withdraw funds from their plan accounts. Federal tax laws limit the circumstances in which such withdrawals can be made before a participant's retirement, but these laws (and most 401(k) plans), permit limited withdrawals in the event of a participant's financial hardship. The hardship distribution rules were substantially amended in 2018 and 2019, so a brief review of the applicable rules is now appropriate. We will also summarize how the President's recent disaster declarations for New York, California and Washington State affect the availability of hardship distributions.

Basic Rules on Hardship Distributions

401(k) plans may (but are not required to) permit participants to withdraw elective deferrals from their accounts in the event of financial hardship. The majority of 401(k) plans do permit hardship distributions.

In particular, a 401(k) plan can permit a participant to receive a distribution of his or her elective deferrals, and earnings on those deferrals, in the event of an "immediate and heavy financial need," to the extent that the amount distributed is not more than what is necessary to satisfy this financial need. Unless a distribution is permitted under another provision of the plan, a hardship distribution can be made only if all the applicable requirements are met.

Under amendments to the Internal Revenue Code enacted in 2018 and 2019, a distribution is considered to be on account of an "immediate and heavy financial need" if the distribution is for:

- Expenses for medical care of the participant or the participant's spouse, dependent, or primary beneficiary under the plan;
- Expenses necessary to prevent the eviction of the participant from his or her residence or a foreclosure on the mortgage on that residence;
- Payments for burial or funeral expenses for the participant's deceased parent, spouse, child, dependent or primary beneficiary under the plan;
- Expenses and losses (including lost income) incurred on account of a federally declared disaster, for participants whose principal residence or principal place of employment is located in the designated disaster area;
- Certain expenses for the repair of damage to the participant's principal residence;
- Costs directly related to the purchase of a principal residence for the participant (excluding mortgage payments); or
- Certain costs of tuition, fees and room and board for up 12 months of post-secondary education for the participant or the participant's spouse, child or dependent.

The amount of a hardship distribution may not be more than the amount needed to relieve the immediate and heavy financial need. A distribution will not be considered necessary to satisfy the financial need unless:

- The participant has obtained all other available distributions under the plan and the employer's other qualified and non-qualified retirement plans (but plans are no longer obligated to require participants to first obtain all available loans from such plans before permitting a hardship distribution);
- The participant represents to the plan administrator in writing that the participant has insufficient cash or liquid assets reasonably available to satisfy the financial need; and
- The plan administrator does not have actual knowledge that is contrary to the employee's representation.

Federal Disaster Declarations

On March 20, 2020, President Trump declared that a major disaster exists in the state of New York as a result of the COVID-19 pandemic, and ordered Federal assistance to supplement State, local, and tribal recovery efforts. On March 22, 2020, the President signed similar disaster declarations for the states of California and Washington.

As a result of these presidential declarations, employees who live or work in New York, California or Washington State can now receive hardship distributions from their 401(k) plan accounts if the plan provides for such distributions. Since this hardship event has only been available for about two years, many plan sponsors may not have amended their plans to include it as a permissible hardship distribution event. Employers with employees who live or work in these three states may wish to consider amending their 401(k) plans to permit hardship distributions in the event of federal disaster declarations.

Hardship distributions triggered by federal disaster declarations are different from other types of hardship distributions in at least two ways:

- *Only the Participant's Costs and Losses Are Covered:* Only disaster-related expenses and losses of an employee who lived or worked in the disaster area will qualify for this type of hardship distribution; those of the participant's spouse, dependents and primary beneficiary are not covered.
- *Lost Income Can Be Replaced:* Distributions on account of a disaster can be used to replace the participant's lost income, in addition to costs and expenses directly related to the disaster. For other types of hardship distributions, only specific categories of expense (like medical expenses) are covered.

Other Qualifying Hardships

Other categories of financial need might also qualify for hardship distributions – for example, expenses for medical care of the participant or the participant's spouse, dependents, or primary beneficiary, or expenses necessary to prevent the eviction of the participant from his or her residence or a foreclosure on the mortgage on that residence. Additional qualifying hardship expenses are summarized above.

Plan sponsors should remember that hardship distributions are permitted *only* if the plan document provides for such distributions. Sponsors should also keep in mind that the hardship distribution rules have significantly changed in the past two years, so they should check the plan documents and administrative procedures to ensure that they are up to date, and that any hardship distributions to be allowed in 2020 are consistent with the plan documents.

The following changes have gone into effect in the last two years with respect to hardship distributions (in addition to the changes mentioned earlier):

- *Six Month Suspension of Employee Contributions No Longer Permitted:* A plan may no longer require that a participant who receives a hardship distribution suspend contributions to other qualified or non-qualified retirement plans of the employer. (Before January 1, 2020, plans were required to impose a six-month suspension on such employee contributions following a hardship distribution.)

- *Additional Sources of Hardship Distributions:* Plans may now permit hardship distributions from employee elective deferrals, employer qualified nonelective contributions and qualified matching contributions (so-called QNECs and QMACs), and earnings on any of the above. (But plans are not required to permit hardship distributions from all these sources.)

403(b) Plans

Hardship distributions from 403(b) plans are subject to many (but not all) of the 401(k) plan rules summarized in this memorandum. The relatively new rule regarding federal disaster declarations applies to 403(b) plans. But some of these 401(k) plan rules apply differently to 403(b) plans. For example, earnings on elective deferrals to a 403(b) plan may not be included in a hardship distribution.

If you have any questions about this memorandum, please contact the attorney at the firm with whom you are regularly in contact or any [attorney](#) in our [Employee Benefits and Executive Compensation Practice Group](#).



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