

New IRS Final Regulations for Hardship Distributions Under 401(k) and 403(b) Plans

Notable Changes and Required Amendments for Retirement Plans, Key Compliance Challenges for Plan Sponsors

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NEW IRS FINAL REGULATIONS FOR HARDSHIP DISTRIBUTIONS UNDER 401(K) AND 403(B) PLANS

BACKGROUND AND OVERVIEW OF REGULATORY CHANGES

Background on Hardships

- ✦ Although not required, a retirement plan may allow participants to receive hardship distributions. A distribution from a participant's elective deferral account can only be made if the distribution is both:
 - > Due to an **immediate and heavy financial need**.
 - > Limited to the **amount necessary** to satisfy that financial need.

Background on Hardships

- ★ Under a “safe harbor” in prior IRS regulations, an employee is automatically considered to have an immediate and heavy financial need if the distribution is for any of these:
 - > Medical care expenses for the employee, the employee’s spouse, dependents or beneficiary.
 - > Costs directly related to the purchase of an employee’s principal residence (excluding mortgage payments).

Background on Hardships

- > Tuition, related educational fees and room and board expenses for postsecondary education for the employee or the employee's spouse, children, dependents or beneficiary.
- > Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.
- > Funeral expenses for the employee, the employee's spouse, children, dependents, or beneficiary.
- > Certain expenses to repair damage to the employee's principal residence.

Background on Hardships

- ★ The amount of a hardship distribution must be limited to the amount necessary to satisfy the need.
- ★ This rule is satisfied if:
 - > The distribution is limited to the amount needed to cover the immediate and heavy financial need, and
 - > The employee couldn't reasonably obtain the funds from another source (see prior safe harbor on next page).

Background on Hardships

- ★ Unless the employer has actual knowledge to the contrary, the employer may rely on the employee's written statement that their need can't be relieved from other available resources, including:
 - > Insurance or other reimbursement.
 - > Liquidation of the employee's assets.
 - > The employee's pay, by discontinuing elective deferrals and after-tax employee contributions.
 - > Plan loans or reasonable commercial loans.

Background on Hardships

- ★ Sources for hardship distributions:
 - > Elective deferrals (not from earnings on elective deferrals)
 - > Employer nonelective contributions (sometimes referred to as “profit-sharing contributions”) and
 - > Regular matching contributions.

Hardship Rule Changes

- ✦ Changes Made by the Bipartisan Budget Act of 2018
 - > No requirement to take plan loans before hardship.
 - > No need to suspend deferrals for six months.
 - > Sources now available – deferral earnings, QNECs, QMACs and Safe Harbor 401(k).

Hardship Rule Changes

- ✦ Proposed Regulations were issued on November 14, 2018.
- ✦ No public hearing was held and 7 comment letters were submitted.
- ✦ Final regulations were issued on September 23, 2019.

Changes Under Final Regulations

- ★ Added a new item to the list of safe harbor reasons to have an immediate and heavy financial need – **expenses or losses incurred by the employee as a result of a FEMA declared federal disaster, provided the employee lives or has a principal place of employment within the disaster area.**
- ★ This was the type of relief the IRS has previously provided on an episodic basis for federal disasters (e.g., floods, hurricanes, and wildfires).

Changes Under Final Regulations

- ★ Added “primary beneficiary” as an individual who could qualify for medical, educational or funeral expenses. This was a law change from the Pension Protection Act of 2006.
- ★ Clarified that the home casualty loss does not have to be in a federally declared disaster area (this was an unintended consequence of TCJA 2017).

Changes Under Final Regulations

- ★ Suspension of elective deferrals or after-tax contributions will no longer be allowed for any reason.
 - > This was previously part of the “other resources” safe harbor test.
 - > Applies to any qualified plan, 403(b) plan, or eligible 457(b) plan.
 - > Final regulations permit a suspension provision with regard to non-qualified plans subject to 409A.
- ★ This change is generally effective as of the beginning of the 2019 plan year. However, there are optional transition rules (next slide).

Changes Under Final Regulations

- ★ ***Optional*** transition rules:
 - > A suspension that started in the last 6 months of the 2018 plan year may be lifted as of the first day of the 2019 plan year.
 - > A six-month suspension may continue to be applied for hardship distributions made before January 1, 2020.

Changes Under Final Regulations

- ✦ Effective for the 2019 plan year, the regulations do away with the requirement that the employee take all available, non-taxable, loans from the plan before receiving a hardship distribution.
- ✦ This change is optional and a plan can still require that a loan be taken first (but why would you?).
- ✦ Employee must still receive all available non-hardship distributions before receiving a hardship distribution.
- ✦ Effective for the 2019 plan year, the regulation eliminates the facts and circumstances methodology for the “other resources” test and now there is ONE general standard (see next slide).

Changes Under Final Regulations

★ General standard

- > Hardship may not exceed amount of the need, increased for anticipated taxes and penalties.
- > Participant must first obtain all other available non-hardship distributions currently available under all of the employer's plans of deferred compensation (both qualified and non-qualified).
 - Preamble indicates that ESOP dividends that have been paid to the plan and are available for distribution are amounts that must be distributed.

Changes Under Final Regulations

★ General standard (cont'd)

- > For distributions made after December 31, 2019, employee must represent that he or she has insufficient cash or liquid assets **reasonably available** to satisfy the financial need.
 - Final regulation adds reasonably available language to clarify that \$\$ earmarked for payment of a future obligation (e.g., rent) may be ignored.
- > Plan administrator may rely on this representation unless there is actual knowledge to the contrary.
 - Preamble indicates that this requirement "... does not impose upon plan administrators an obligation to inquire into the financial condition of employees seeking hardship. Rather, the rule is limited to situations in which the plan administrator already possesses sufficiently accurate information to determine the veracity of an employee representation."
 - Certification can be in writing or electronically in accordance with the IRS e-disclosure regulation 1.401(a)-21(e)(3).

Changes Under Final Regulations

- ★ Sources for hardship expanded
 - > Elective deferrals PLUS earnings.
 - > QNECs, QMACS, safe harbor contributions – all of these plus earnings.
 - > Note that this is optional and plans may still limit the available sources for a hardship distribution (for example, only from the elective deferral account including accrued earnings).

A note on 403(b) Arrangements

- ✦ §403(b) arrangements
 - > Income allocable to elective deferrals is still not eligible for hardship – this needs a technical correction to IRC §403(b)(11).
 - > 403(b)(7) custodial account plans are limited by IRC §403(b)(7)(A)(ii) so that a distribution of any kind may only be paid at death, disability, age 59 ½, or severance from employment.
 - > In addition, elective deferrals may be paid on account of hardship.
 - > QNECs and QMACs that are not in 403(b)(7) custodial accounts are eligible for a hardship distribution.

Thank You



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New IRS Final Regulations for Hardship Distributions Under 401(k) and 403(b) Plans

Required Amendments for Retirement Plans and Key Considerations and Compliance Challenges for Plan Sponsors

Mamta Shah, Partner
Constance Brewer, Senior Associate

December 12, 2019



Mamta Shah, Partner

Mamta has experience advising public and privately-held companies on all aspects of employee benefits law, including the implementation, design and administration of qualified employee benefit plans (such as 401(k) plans, profit sharing plans and defined benefit plans), nonqualified deferred compensation arrangements, health and welfare plans, and severance, stock option and other equity and/or incentive based compensation plans. She also has experience in employee benefits issues arising in the context of business transactions, such as corporate mergers, acquisitions and dispositions, with an expertise in benefits integration and disintegration.



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Constance advises clients on compensation and benefits issues associated with corporate transactions, including negotiating transaction documents, drafting employee communications, performing 280G analyses, conducting due diligence, and assisting with benefits and compensation integration issues. She also advises clients on all aspects of defined contribution and defined benefit plans, including plan design, administration, compliance, governmental submissions, plan amendments, participant communications, plan merger and termination, and withdrawal liability and mitigation for multiemployer plans.

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Necessary Amendments for Retirement Plan Documents

Final Hardship Withdrawal Regulations – Required Amendments – Effective Dates

Required Amendment	Earliest Permissible Effective Date	Latest Effective Date
Remove any contribution suspension provisions (e.g., no 6 month delay)	Hardship distributions made in plan years beginning after December 31, 2018 (may be applied to distributions made in prior plan year)	Hardship distributions made on and after January 1, 2020
Add employee representation requirement (new immediate and financial need standard)	Hardship distributions made in plan years beginning after December 31, 2018	Hardship distributions made on and after January 1, 2020

Final Hardship Withdrawal Regulations – Optional Amendments – Effective Dates

- **Expand sources for hardship distribution** (optional as early as 2019 plan year)
 - 401(k) Plans – earnings on elective deferrals, QMACs, QNECs, 401(k) safe harbor contributions and earnings
 - 403(b) Plans – QMACs and QNECs only if not held in a custodial account (no earnings available for distribution)
- **Remove plan loan first mandate** (optional as early as 2019 plan year)
- **Add FEMA-declared disaster safe harbor hardship expense** (optional as early as January 1, 2018)
- **Add “primary beneficiary” as an individual for whom qualifying medical, educational and funeral expenses may be incurred**
- **Apply casualty loss deduction safe harbor without limitation in IRC § 165(h)(5) for losses relating to federally declared disaster** (optional as early as January 1, 2018; IRC § 165(h)(5) limitation removed from regulatory safe harbor list for distributions effective on and after January 1, 2020)

Final Hardship Withdrawal Regulations – Amendment Deadlines

Amendment deadlines differ depending upon the:

- Type of Amendment – required to correct a disqualifying plan provision, integrally related to a change in qualification requirements, or discretionary
- Type of Plan – individually designed plan, pre-approved plan, 401(k) plan, or 403(b) plan
- Type of Plan Sponsor – plan maintained by a non-government or government employer

Final Hardship Withdrawal Regulations – Amendment Deadlines – Individually Designed 401(k) Plans

Required Amendments – December 31, 2021 (Notice 2019-64)

- Remove plan provisions requiring suspension of deferrals upon hardship
- Add employee representation requirement for hardship

Integrally Related Amendments – December 31, 2021 (Preamble to Final Regulations)

- An amendment that is “integrally related” to a changed qualification requirement is a “plan amendment modifying a plan’s hardship distribution provisions that is effective no later than the required amendment, including a plan amendment reflecting one or more of the following”:
 - A change to IRC 165 relating to casualty loss;
 - Addition of new FEMA-disaster safe harbor expense; and
 - Extension of relief for victims of Hurricanes Florence and Michael.
- Essentially, these are optional hardship amendments effective on or before January 1, 2020.

Discretionary Amendments effective after January 1, 2020 – Last day of plan year during which the amendment is effective

**Extended deadlines may apply to governmental plans.*

Final Hardship Withdrawal Regulations – Amendment Deadline – Pre-approved 401(k) Plan Interim Amendments

- **Generally, the required and integrally related hardship withdrawal amendment deadline is the plan sponsor’s tax-filing deadline (plus extensions) for the 2020 tax year, even if provisions were implemented earlier than 2020. (Preamble to Final Regulations)**
 - Example (Calendar Tax Year) - For a C-Corporation with a calendar-year tax year, the amendment deadline is April 15, 2021 (unless the return is extended).
 - Example (Non-Calendar Tax Year) - For a C-Corporation with a fiscal tax and plan year ending June 30, the amendment deadline is October 15, 2020 (unless the return is extended).
- **IRS is considering whether to provide a later or fixed deadline for pre-approved plan amendments unrelated to the tax return due date.**
- **Consult with legal counsel to ensure that amendment deadlines are met.**

Final Hardship Withdrawal Regulations – Amendment Deadline – 403(b) Plans

- **Individualized 403(b) Plans – (Preamble to final regulations; Notice 2019-64; Rev. Proc. 2019-39)**
 - Required and integrally related amendment deadline (i.e., amendments relating to the final regulations adopted on or before January 1, 2020) – December 31, 2021
 - Discretionary amendments – generally last day of the calendar year in which the amendment is operationally put into effect
- **Pre-approved 403(b) Plan (Rev. Proc. 2019-39)**
 - Generally, the deadline is March 31, 2020 but for form defects occurring as a result in a change in law, the amendment deadline is the later of March 31, 2020 and the end of the calendar year after the calendar year in which the change in law is effective. Many pre-approved plan sponsors are recommending amendment by March 31, 2020.
- **Consult with legal counsel to ensure that amendment deadlines are met.**

**Extended deadlines may apply to governmental plans.*

Final Hardship Withdrawal Regulations – Unfunded Nonqualified Deferred Compensation Plan Considerations

- Prohibition on 6-month suspension does not apply to 409A plans.
- Sponsors may choose to retain the suspension or amend, to the extent permitted under IRC § 409A and related regulations, their 409A plans to remove the suspension.

Key Considerations and Compliance Challenges for Plan Sponsors

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

I. Implementation and design considerations

A. Required changes

- Elimination of 6-month suspension requirement on employee deferral and after-tax contributions
- Addition of employee representation requirement

B. Optional changes

II. Effective date of changes – special considerations for safe harbor 401(k) plans

A. Annual safe harbor notice requirement

B. Mid-year change requirements

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

III. Alignment of plan document with administration of required and optional changes

- A. Timely adoption of required amendments
- B. Timely adoption of optional amendments
- C. Ensure plan document correctly reflects effective date of each change that is implemented in operation

IV. Employee communications

- A. Update summary plan description
- B. Safe harbor 401(k) plans – safe harbor notice

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

V. Other Considerations and Compliance Challenges

- A. Dual-qualified plans – compliance with Puerto Rico Internal Revenue Code
- B. Nonqualified plans subject to Internal Revenue Code Section 409A

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Implementation – Required Changes

Elimination of 6-Month Suspension Requirement

6-month suspension on elective deferrals and after-tax contributions can no longer be imposed under any 401(k), 403(b) or eligible 457(b) plan

- Effective date
 - required for hardship distributions made on or after January 1, 2020
 - earlier effective date: plan sponsors can choose to eliminate the 6-month suspension period under their plan starting January 1, 2020, for hardship distributions received after July 1, 2019
- If the 6-month suspension period is eliminated starting January 1, 2020, including for hardship distributions taken during the second half of 2019, a procedure must be established to ensure that affected employees have the opportunity to resume contributions starting January 1, 2020

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

- Contributions may automatically resume based on the most current election in effect
- Employees must make a new election to resume contributions
- Requires coordination between the plan administrator, the plan's third party administrator, and employer's payroll

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Implementation – Required Changes

Employee Representation of Financial Need

Employee must certify to the plan administrator that he or she has insufficient cash or other liquid assets reasonably available to satisfy the need

- Hardship distribution not permitted if plan administrator has actual knowledge that is contrary
- If hardship requests are processed by plan's third party administrator, without involvement of plan administrator, establishment of a process to confirm whether the plan administrator has actual knowledge that is contrary to the employee's certification will be necessary

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Implementation/Design Decisions – Optional Changes

Expansion of sources from which hardship distributions may be made: all earnings on elective deferrals, QNECs (and all related earnings), QMACs (and all related earnings), and 401(k) safe harbor contributions (and all related earnings)

- Employer's retirement program philosophy
 - Employer maintains the plan to allow employees to save for retirement
 - Flexibility to receive hardship distributions may encourage employees to make their own employee contributions to the plan
- Increased flexibility/streamlined plan administration
 - Prior to the changes made under the new hardship withdrawal rules, employees could take hardship withdrawals of their employee deferral contributions and pre-1989 earnings on those contributions

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

- Plans that did not separately track pre-1989 and post-1988 earnings on elective deferral contributions did not allow hardship withdrawals from an employee's elective deferral account or did not allow withdrawals from any earnings related to elective deferral contributions
- Adds significantly greater flexibility for safe harbor 401(k) plans

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Implementation – Optional Changes

Elimination of Requirement to First Obtain Loans

Plan sponsors can choose to eliminate the requirement that employees first obtain all available, non-taxable loans from the plan and other plans

- Options that a plan sponsor may consider:
 - Eliminating the requirement that employees first obtain loans – provides greater flexibility to employees and streamlines plan administration
 - Retaining the requirement that employees first obtain loans from the plan and other plans – less flexibility for employees, greater administrative burden for plan sponsor especially if there is more than one plan in the controlled group
 - Limiting the requirement to first obtaining loans from the plan, but not other plans – less flexibility for employees

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Implementation – Optional Changes

Expansion of Safe Harbor Hardship Reasons

- Employers can allow employees to take a hardship withdrawal for
 - Expenses and losses incurred as a result of FEMA-declared disasters
 - Medical, education and funeral expenses incurred by employee for primary beneficiary
- Plan sponsors are not required to expand the reasons for which hardship distributions would be permitted, and may decide to add additional withdrawal reasons at a later date
- Adding hardship withdrawals for FEMA-declared disasters
 - IRS does not intend to issue announcements providing for special hardship withdrawal rights on a periodic basis in connection with specific FEMA-declared disasters
 - Would eliminate any delay or uncertainty regarding access to plan funds following major disasters

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

- Permitting hardship withdrawals for medical, education and funeral expenses incurred by employee for primary beneficiary
 - Concern: would encourage employees to change beneficiaries for sole purpose of receiving hardship withdrawals for expenses incurred by a specific beneficiary
 - Increased flexibility for employees: would allow employees to receive hardship withdrawals for certain expenses incurred with respect to a partner who is not a spouse

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Effective Date of Changes – Special Considerations for Safe Harbor 401(k) Plans

- Required changes are effective for hardship distributions made on or after 1/1/2020
- For safe harbor plans with calendar year plan years: the hardship withdrawal changes that are effective starting 1/1/2020 must be included in the safe harbor notice for 2020
 - If not already included, employees must receive an updated notice reflecting the new hardship withdrawal provisions and be provided a reasonable opportunity to change their deferral elections
- For safe harbor 401(k) plans that are not calendar year plans, implementing the required hardship changes effective 1/1/2020 will result in a mid-year change
 - Mid-year amendment rules apply - generally, a mid-year safe harbor change notice must be provided to employees at least 30 but not more than 90 days prior to the effective date of the change and employees must be provided at least 30 days before the effective date of the change to modify their deferral election

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

- Optional changes that are effective after 1/1/2020
 - Changes that are effective as of the beginning of a plan year (e.g., for a calendar year plan, as of January 1, 2021)
 - The annual safe harbor notice for the year in which the changes are to be effective must include the changes
 - Changes that are implemented mid-year
 - Mid-year amendment rules apply - a mid-year safe harbor change notice must be provided to employees at least 30 but not more than 90 days prior to the effective date of the change and employees must be provided at least 30 days before the effective date of the change to modify their deferral election

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Alignment of Plan Document With Administration of the Plan

- Ensure plan document correctly reflects each required and optional change that is implemented
- Requires coordination with the plan's third party administrator
- Plan document must be timely amended to reflect the required and optional changes that are implemented, which would include
 - the effective date of each change, and
 - the provisions of the implemented change (e.g., suspension of 6-month requirement effective 1/1/2020 versus suspension of 6-month requirement for hardship distributions made on or after 1/1/2020)

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Addressing Plan Document/Operational Failures Arising from New Hardship Rules

- Failure to timely adopt amendments reflecting required or optional changes implemented in operation
 - Correction under IRS' Employee Plans Compliance Resolution System ("EPCRS") (Revenue Procedure 2019-19) – adoption of retroactive amendments to conform terms of the plan to the operation of the plan
 - Self-Correction Program (SCP)
 - Voluntary Compliance Program (VCP)
- Failure to operate the plan in accordance with adopted changes
 - Failure to remove 6-month suspension requirement in operation – correction to be made applying the same principles for exclusion of eligible employees which will generally involve a corrective contribution

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Employee communications

- Provide updated summary plan description or summary of material modifications describing hardship changes
 - Deadline: no later than 210 days following the end of the plan year in which the changes are adopted
 - Calendar year plan that is individually-designed plan: if the amendments are adopted in 2021, the updated summary plan description/SMM must be distributed by July 29, 2022
- Safe harbor 401(k) plans – safe harbor notice for 2020
 - Hardship withdrawal changes must be included in safe harbor notice
 - If not already included, employees must receive an updated notice reflecting new hardship withdrawal provisions and reasonable opportunity to change their deferral elections

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Miscellaneous – Other Key Considerations and Compliance Challenges

Dual-qualified plans – compliance with Puerto Rico Internal Revenue Code

- Dual-qualified plans must comply with the requirements of both the US Internal Revenue Code and the Puerto Rico Internal Revenue Code
 - The Puerto Rico Code permits hardship distributions to employees residing and working in Puerto Rico
 - The Puerto Rico Internal Revenue Code continues to impose a suspension requirement and a loan first requirement for receiving a hardship withdrawal
 - Potential considerations:
 - Exclude Puerto Rico employees from receiving hardship distributions – would require nondiscrimination testing

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

Nonqualified plans subject to Internal Revenue Code Section 409A

- Prohibition on 6-month suspension does not apply to 409A plans - non-qualified plans may retain provisions cancelling deferral elections following a hardship distribution from the employer's qualified plan
- Sponsors may choose to retain the suspension or amend, to the extent permitted under 409A, their 409A plans to remove the suspension
- Administrative considerations:
 - following elimination of the 6-month suspension requirement under the employer's qualified plan, the plan administrator may no longer receive notice from the plan's third-party administrator that a hardship distribution was processed for an employee - if the suspension requirement under an employer's non-qualified plan is retained, the plan administrator may not receive information needed to cancel deferral elections under the non-qualified plan

Final Hardship Withdrawal Regulations – Key Considerations and Compliance Challenges

- depending on when the 6-month suspension period is eliminated under the qualified plan, the suspension requirement under the non-qualified plan can not be removed by reinstating an employee's canceled election under the nonqualified plan

Thank You!

Questions?

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