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Plan sponsors jump to meet changes over withdrawals

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Michael Francis thinks most organizations are prepared for changes. | BRETT KRAMER

Sponsors of 401(k) and 403(b) plans and their record keepers are moving quickly to satisfy new IRS regulations that will make it easier for plan participants to take hardship withdrawals from their retirement accounts.

Beginning Jan. 1, employees will be able to keep contributing to their accounts should they need to withdraw funds for hardships such as medical expenses. That marks a departure from previous IRS rules that required employers to suspend employee contributions for six months following a hardship distribution.

The new rule is part of a package of mandatory and voluntary measures that the IRS developed at Congress' behest to ease restrictions on hardship withdrawals. Plan sponsors will, for example, also be able to allow participants to withdraw qualified employer contributions, which was previously forbidden, and will no longer have to require participants to take all available plan loans before taking a hardship withdrawal.

The regulations — finalized Sept. 23 after a nearly yearlong comment and review period — have earned support among plan sponsors as they look to encourage participants to preserve their retirement savings while also giving them access to the funds for true financial hardships. While some sponsors had concerns about plan leakage, the flexibility of the rules helped alleviate those worries, industry observers said.

Participants already face significant deterrents to taking hardship distributions because they must pay taxes on the money plus a 10% early withdrawal penalty if they're under 59½, an obstacle that will not change with the new rules, said Brenda Grabowski, the Milwaukee-based total rewards manager in the human resources department of Mortgage Guaranty Insurance Corp., a publicly traded mortgage insurance company.

"When we do have a participant that needs to do that, it's really their last resort option," she said of participants who request hardship distributions from the $320 million 401(k) plan. Why then, she asked, would the company further penalize participants in already difficult financial situations by suspending their contributions or forcing them to take a loan they can't repay.

Michael Francis, president and chief investment officer of registered investment adviser Francis Investment Counsel LLC in Brookfield, Wis., sees many clients sharing similar views. "Our experience talking with plan sponsors is that they are by and large adopting the whole package hook, line and

sinker," he said of the new regulations. "Even organizations that are protective (of preserving savings) are saying, 'Look, if it is in fact a true financial need, we should do this.' "

New verification process

In addition to requiring plan sponsors to stop the six-month suspension of participant contributions, the regulations mandate that employers follow a new process for verifying an employee's need for hardship funds beginning Jan. 1. Before granting a withdrawal, plan sponsors will need to get certification from the employee attesting that he or she does not have assets reasonably available to meet the hardship at hand, said Michael Hadley, a partner with Davis & Harman LLP in Washington.

Plan sponsors will be able to rely on that certification unless they have actual knowledge to the contrary, Mr. Hadley said. They must also make sure that employees have taken all other available distributions from the plan and other retirement plans offered by the employer, such as distributions of employee stock ownership plan dividends or distributions available when they turn 59½, he said.

Before, if an employee did not qualify for one of six safe-harbor expense categories, such as a funeral bill or home foreclosure notice, the employer would have to determine if the requested hardship withdrawal was necessary, a process that experts say was laborious.

"The intent is to remove the subjectivity of the process and just say, 'Here's what you have to do — boom, boom, boom,' " Mr. Francis said of the new certification process.

While plan sponsors generally agree with the required changes, they are facing a tight deadline to implement them given that the final version of the rules were approved in late September.

"That's three months to not only make the systems changes but if you're a service provider to communicate it to plan sponsors," said Mr. Hadley, adding that record keepers need to change election forms and make sure that notices that go to participants near the end of the year reflect the updated hardship distribution rules.

"Three months is a pretty short window of implementation for significant changes to plan administration," Mr. Hadley said.

Many 401(k) record-keeping platforms, for example, do not have the new employee certification built in, and need to be built and tested before year-end.

"I think they're working hard and they're going to have to devote resources that could have been devoted to other IT improvements," Mr. Hadley said.

Still, plan sponsors and record keepers are widely expected to be ready for the changes in part because the changes were anticipated, according to industry observers.

"My sense is that the organizations that we deal with and work with are on top of this. They're aware of it. They understand it and they've communicated or are in communication with the record-keeping organization about this," Mr. Francis said.

2 voluntary measures

In addition to implementing the required changes by Jan. 1, plan sponsors will have to decide whether to adopt two additional voluntary measures, which they can implement at any time. Employers may choose to remove the current requirement that participants first take all available loans prior to taking a hardship withdrawal from the plan. They may also opt to allow plan participants to withdraw earnings on their own

deferrals as well as employer qualified non-elective contributions and qualified matching contributions and earnings on those contributions, money that the IRS previously expressly excluded as sources available for hardship withdrawals.

For 403(b) plans, however, the optional expansion of withdrawal sources is more restrictive. Non-custodial 403(b) plans may only expand hardship withdrawal sources to qualified non-elective contributions and qualified matching contributions, and custodial 403(b) plans are not allowed to expand their hardship withdrawal sources at all.

Of all the required and voluntary changes, the removal of the six-month suspension of employee contributions following hardship distributions has the widest support, according to industry observers.

"That has resonated with virtually everybody that we've talked to," Mr. Francis said, referring to the ability that participants will have under the rules to continue contributing to their retirement accounts after taking a hardship withdrawal. "If they can afford to, why wouldn't we want them to?" he asked.

Alicia Munnell, director of the Center for Retirement Research at Boston College, said she never thought keeping participants from contributing to their accounts was a good idea. "There's no point keeping them out of their only main savings vehicle for an unnecessarily long time," she said.

Plan sponsors also applauded the IRS for adding a new safe-harbor category allowing employees to take hardship distributions for expenses and losses related to federally declared disasters. Until now, the IRS has made special disaster relief announcements that permitted such distributions.

The new safe harbor will allow plans to make distributions "without waiting for the IRS to come out after each disaster and say you can do this," said Jan Jacobson, senior counsel on retirement policy matters at the American Benefits Council in Washington.

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