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A Lifeline from the Taxman: IRS Temporarily Broadens Access to Retirement Funds for Victims of Hurricane Harvey

Gray Reed Legal Alert

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On August 30, the IRS issued Announcement 2017-11 (the “Announcement”), which indicates that 401(k) plans and similar employer-sponsored retirement plans can allow access to those funds through loans and hardship distributions to victims of Hurricane Harvey. A participant who lives outside the disaster area is also allowed to take a retirement plan loan or hardship distribution in order to assist a son, daughter, parent, grandparent or other dependent who lived or worked in the disaster area.

This sounds like great news for employers who want to help both plan participants and relatives of plan participants who were affected by this devastating storm. But before employers get carried away with their generosity, they have to understand the rules – and even more exceptions – that typically apply to both plan loans and hardship distributions, and how the Announcement temporarily impacts these rules.

PARTICIPANT LOANS

All participant loans must meet certain requirements which have to be included in the retirement plan’s provisions in order to avoid being considered prohibited transactions. The IRS Code (the “Code) requires that participant loans:

1. Be available to all participants on an equivalent basis,
2. Bear a reasonable rate of interest,
3. Specify how long the repayment period is and contain a repayment schedule, and
4. Be adequately secured.

The maximum amount a participant can borrow from his or her plan is 50 percent of the vested account balance, or $50,000, whichever is less. However, if 50 percent of the vested account balance is less than $10,000, the participant can borrow up to $10,000.

Repayments of the 401(k) loan must be made at least quarterly and the repayment period cannot exceed five years. If it does, the loan will be considered a taxable distribution. There is an exception to that rule: Loans used to acquire the principal residence of the participant are not subject to the 5 year limit.

The plan can provide for repayment of a loan even after the employee has been terminated. It can also provide that once employment is terminated, any outstanding loan balances become due, in which case the loan balance would be deducted from any amounts due to be distributed to the participant. If the participant is under age 59 ½ and defaults on the loan, he or she will be subject to a 10 percent additional tax.

HARDSHIP DISTRIBUTIONS

Participants typically can't take out "in-service" distributions from defined contribution plans, such as 401(k) and 403(b) plans, until they are 59 ½ years of age. This is where the "hardship distribution" rules come in. They allow participants to take money out of the plan if they have a bona fide "hardship".

Hardship distributions of amounts attributable to elective deferral contributions are permitted only if they are (a) made to satisfy an immediate and heavy financial need, and (b) in an amount necessary to satisfy that need.

What constitutes an "immediate and heavy financial need"?
Under the safe harbor provisions, a participant is deemed to have an immediate and heavy financial need if a hardship distribution is for any of the following circumstances:

1. Unreimbursed medical expenses,
2. Purchase of a principal residence,
3. Payments needed to prevent eviction from the participant's home or foreclosure on the participant's principal residence,
4. Tuition for college education for the next 12 months,
5. Payments for funeral expenses, or
6. Certain expenses for the repair of damage to the participant's principal residence.

A participant can also use a "facts and circumstances" test but the financial need cannot be reasonably relieved via other sources of income, including nontaxable loans currently available under all plans maintained by the employer.

An Important Note for Hardship Distributions:
Hardship distributions are subject to the 10 percent early withdrawal tax imposed unless an exception applies. For example, if the hardship withdrawal is made after the date on which the participant attains age 59½, the distribution is not subject to the 10 percent penalty.

The employer can rely on the participant's written representations regarding the need for the loan, and there is no duty to investigate unless the employer has actual knowledge to the contrary.

IMPACT OF THE ANNOUNCEMENT IN REGARDS TO HURRICANE HARVEY

While the guidance issued by the IRS keeps the requirements above (for the most part) intact, it does allow employers with plans that do not currently allow for participant loans or hardship distributions to amend these plans by no later than the end of the first plan year beginning after December 31, 2017. To qualify for relief under the Announcement, hardship distributions must be made on account of a hardship resulting from Hurricane Harvey and be made on or after August 23, 2017 and no later than January 31, 2018.

Participants typically cannot make contributions to a retirement plan for six months after taking a hardship distribution. This is another area where the IRS provided relief, as the Announcement specifically indicates that the six month ban on 401(k) and 403(b) contributions that would normally apply will not affect participants who take a hardship distribution because they were victims, or have family members who were victims, of Hurricane Harvey.

WHAT THIS MEANS FOR PLAN ADMINISTRATORS

Although the Announcement provides temporary relief of certain rules in order to facilitate participant loans and hardship distributions, it also reminds plan administrators that the rules that impact plan loans and hardship distributions are still in place even if temporarily suspended. This means that the normal spousal consent rules for loans and hardship distributions apply, that any hardship distributions made will be includible in gross income, and that – generally speaking – the 10 percent additional tax applies.

The Announcement also indicates that although plan administrators are required to make reasonable attempts to assemble any forgone documentation, a retirement plan will not be treated as failing to follow procedural requirements for plan loans or hardship distributions just because those requirements are disregarded during the period indicated above.

WHAT ABOUT IRAS?

The Announcement also applies to IRAs. It relaxes the procedural requirements for distributions from IRAs made between August 23, 2017 and January 31, 2018. As long as financial institutions make a good faith effort to gather any missing documentation as soon as practicable, they can immediately facilitate IRA distribution to victims of Harvey or their family members.

NEXT STEPS

Those employers who wish to provide participant loans and/or hardship distributions under the Announcement should consider acting quickly. Those wishing to expedite distributions under existing retirement plan provisions are also urged to make sure these distributions are both covered by the Announcement and brought into procedural compliance in a timely fashion.

If you have any questions regarding this subject or need assistance, please contact your attorney or Ricardo J. Rivera at 469.320.6030 or rrivera@grayreed.com.

ABOUT THE AUTHOR

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Ricardo Rivera has broad experience in tax and corporate transactional matters. He has an extensive background in handling and structuring business transactions, partnership and corporate tax planning and corporate governance in a variety of areas.

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