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Hardship Distributions from 401(k) Plans

It's four o'clock on Friday afternoon and there's a knock on the door of the Human Resource Manager's office. It's Zachary, a fairly new employee who entered the company's 401(k) plan last month. He's been deferring \$40 a week into the plan, which means he has accumulated \$160 by now. But last night his cable TV was shut off because he couldn't afford to pay the bill and from his 23-year-old point of view, retirement seems like a long way off.

He explained his situation to the H.R. Manager and asked if he could get his deferrals back so he could reconnect the cable. After all, it was his money. The H.R. Manager explained that under the terms of the plan the only type of distribution available to someone younger than 59½ who is still employed is a hardship distribution. Zachary's eyes lit up. "Yeah, a hardship distribution," he repeated. "That's what I want."

For this young man, living even one day without cable TV seemed like a perfect example of a "hardship." But the Internal Revenue Code has a somewhat different interpretation. What follows is a close-up look at the rules concerning hardship distributions.

Does the Plan Permit Hardship Distributions?

A defined contribution plan is not required to provide for in-service distributions in the event of hardship. To permit hardship distributions, appropriate language must be contained in the plan document. The type of retirement plan most likely to offer hardship distributions is the ever-popular 401(k) plan, funded primarily by employee salary deferrals.

Because these accounts are funded by employees' own contributions, many employers feel an obligation to make them available in times of need. It also provides a feeling of security that may encourage participation which can help increase allowable deferral limits for the highly compensated employees. Hardship is the only allowable reason for an in-service distribution from salary deferral accounts prior to age 59½.

Many profit sharing plans do not contain hardship provisions for employer-funded accounts such as matching and profit sharing contributions. If the employer chooses to allow hardship distributions from employer-funded accounts, it has the discretion as to how hardship will be defined, unlike salary deferral distributions which are subject to restrictive IRS requirements.

However, in order to simplify plan administration, some plan documents apply the more restrictive salary deferral hardship withdrawal requirements to hardship withdrawals from employer-funded accounts.

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What Qualifies as a Hardship?

To receive a hardship distribution from salary deferral accounts, a plan participant must have an “immediate and heavy” financial need that can’t be met in any other way.

The determination as to whether or not a participant has an immediate and heavy financial need is based on all relevant facts and circumstances. However, IRS regulations provide a safe harbor list of events which are automatically deemed to satisfy the financial need requirement. Nearly all 401(k) plans utilize the six IRS safe harbor events which are as follows:

- Certain unreimbursed medical expenses for the participant or the participant’s spouse, children, dependents or beneficiaries;
- Costs related to the purchase of a participant’s principal residence, excluding mortgage payments;
- Tuition, related educational fees and room and board expenses for up to the next 12 months of post-secondary education for the participant or the participant’s spouse, children, dependents or beneficiaries;
- Payments necessary to prevent the eviction of the participant from the participant’s principal residence or foreclosure on the mortgage on that residence;
- Burial or funeral expenses for the participant’s parents, spouse, children, dependents or beneficiaries; or
- Certain expenses to repair damage to the participant’s principal residence that qualify for the casualty loss deduction.

Reimbursement of casualty losses is a relatively new addition to the safe harbor list. According to the IRS, casualty loss hardship distributions are allowed for *“the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected or unusual...”* This definition includes occurrences like earthquakes, fires, floods, hurricanes, tornadoes and terrorist attacks but not progressive deterioration such as a steady weakening of a building due to normal wind and weather conditions or termite damage.

The amount of the distribution cannot exceed the amount necessary to satisfy the financial need but it may include amounts required to pay taxes and penalties due on the distribution. For example, the participant cannot receive a hardship distribution of \$10,000 if only \$2,000 is needed but can increase the \$2,000 amount needed to include estimated taxes and penalties.

Are Other Financial Resources Available to the Participant?

Even if a participant can demonstrate an immediate and heavy financial need, the participant must show that the need can only be satisfied by a withdrawal from his or her salary deferral account and that the need cannot be satisfied by other sources that are reasonably available to the participant.

Under the facts and circumstances test, a withdrawal will be deemed necessary if the need cannot be satisfied from other sources, including sources reasonably available to the participant from a spouse or minor child. Unless the plan sponsor has actual knowledge to the contrary, the plan sponsor may rely on the participant’s written statement that the need cannot be relieved from other available resources including:

- Reimbursement or compensation by insurance or otherwise;
- Liquidation of the participant’s assets;
- Cessation of elective or other employee contributions to the plan;
- Other currently available distributions and loans from plans maintained by any employer; or
- Borrowing from commercial sources on reasonable terms.

Any of the sources listed above will not be considered an available source if it results in an increase in the amount of the financial need.

A plan can choose to utilize a safe harbor test in which case the distribution will be deemed necessary to satisfy the need if both of the following requirements are met:

- The participant has obtained all other currently available distributions and loans from all plans maintained by the employer; and
- The participant is prohibited from making elective and other employee contributions to any plan maintained by the employer for at least six months after receipt of the hardship distribution (this suspension rule does not apply to mandatory employee contributions to a defined benefit plan or to a health or welfare benefit plan).

Plan Loans vs. Hardship Distributions

Plan sponsors may be confused by the requirement that all available plan loans must be taken before becoming eligible for a hardship distribution. After all, if the plan allows for loans, how can you justify approving the hardship distribution without first requiring that the loan be taken? The IRS regulations provide that any available loan not serve to merely increase the extent of the financial hardship.

In many situations the burden of loan repayments and additional debt on the participant's credit report could worsen the participant's financial situation. For example, the additional debt of a plan loan could disqualify a participant from obtaining the mortgage needed to purchase a home.

What Funds are Available for Hardship Distribution?

Different rules apply depending upon the source of funds being withdrawn:

Employee Deferral Accounts

Only the accumulated employee deferrals may be distributed—investment earnings may not be distributed except for certain earnings accumulated in the plan prior to 1989.

Employer-Funded Accounts

The plan may permit the entire vested employer-funded account balance to be distributed, including earnings. Employer qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) made for purposes of passing nondiscrimination testing may not be distributed as in-service distributions unless the employee has attained age 59½ (an exception applies for QNECs and QMACs credited prior to 1989). Also, employer safe harbor 401(k) contributions may not be distributed.

Documentation

The IRS expects the plan sponsor to require proof of financial need before authorizing a hardship distribution from the plan. Simply relying on the reason that is checked on the hardship request is not enough. Proof may include copies of medical bills and insurance statements, past due notices from the landlord or mortgage company, copies of college tuition bills, etc.

The ability to request hardship distributions electronically is growing in popularity. During this process, participants self-certify that they meet the hardship criteria. The IRS has made it clear that electronic self-certification does not relieve the plan sponsor of the need to gather documentation of the immediate and heavy financial need.

It is important that the plan sponsor retain a record of all information used to determine whether a participant was eligible for a hardship distribution and the amount distributed was the amount necessary to alleviate the hardship. If the plan is audited by the IRS, the agent will look for this documentation.

Taxation

Hardship distributions are taxable in the year received and are includible in gross income unless they consist of designated Roth contributions. In addition, they may be subject to an additional 10% early withdrawal penalty if the participant has not reached age 59½. Hardship distributions are not eligible for rollover to an IRA or another qualified plan and may not be repaid to the plan.

Conclusion

Hardship distributions are a valuable component of many 401(k) plans. They encourage participation in the plan and provide a sense of security to participants as they seek a balance between retirement savings and current financial needs.

Authorizing plan distributions that do not satisfy the IRS hardship requirements can result in plan disqualification and adverse tax consequences for the participants and the plan sponsor. Therefore, it is important for plan sponsors to understand the hardship distribution requirements and to make sure their hardship distribution paperwork is in order.

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