

401(k) Plan Administration: Hardship Distributions

By Jim Wagenmann

In the current economic climate, many 401(k) plan participants are looking at the funds in their retirement accounts and examining ways to distribute those funds to alleviate current financial difficulties. Generally, 401(k) plans are not allowed to make distributions to participants except in limited circumstances. As allowed under the applicable regulations, some 401(k) plan documents allow participants to tap into their retirement funds before retirement through “hardship distributions,” if their financial difficulties meet certain qualifications. If a 401(k) plan document does not allow for hardship distributions, the employer may amend the document to allow for such distributions.

A distribution that qualifies as a hardship distribution is subject to income tax on the amount distributed and may also be subject to the 10 percent penalty normally applicable to early withdrawals from such plans. A plan participant may receive a hardship distribution for an “immediate and heavy” financial need that can be met only with funds from the 401(k) plan. Determining whether a need is immediate and heavy and the amount required to satisfy that need is dependent on the terms of the plan document.

A hardship distribution must be limited to a maximum amount equal to the employee’s elective contributions as of the date of the distribution, less any previous distributions of elective contributions. The maximum for a hardship distribution does not include any earnings on contributions to the 401(k) plan, qualified non-elective contributions or qualified employer matching contributions. The amount of a hardship distribution is also limited to the amount needed to satisfy the participant’s immediate and heavy need, plus the amount needed to satisfy any anticipated federal, state or local income taxes arising from the distribution.

The IRS has established a safe harbor for a determination of an immediate and heavy need, such that distributions responsive to the following expenses will qualify as a hardship distribution, if the employee has no other source of funds to meet the need:

- Deductible medical expenses (without regard to the adjusted gross income limits on deductibility) of the employee, the employee’s spouse or a dependent of the employee;
- Costs related to the employee’s purchase of a principal residence (excluding mortgage payments);
- Costs of postsecondary tuition and educational expenses of the employee, the employee’s spouse or a dependent of the employee, for a maximum of 12 months;
- Payments necessary to prevent the employee’s eviction from the employee’s principal residence or foreclosure on the mortgage of the employee’s principal residence;
- Expenses for the burial or funeral of the employee’s parents, spouse, children or dependents; or
- Expenses to repair damage to the employee’s principal residence that would qualify as a casualty deduction (without regard to the adjusted gross income limits on deductibility).

In other situations, the plan administrator must determine whether an employee’s need is immediate and heavy based on all relevant facts and circumstances. In most cases, a plan administrator may rely on an employee’s written certification that the employee has an immediate and heavy need and that the employee has no other funds available to meet the need.

If the plan administrator, however, has actual knowledge that the employee has access to other sources of funds or assets that could be used to alleviate the need, the administrator must inquire as to the availability of those sources before approving the hardship request. An employee may obtain other funds through:

- Compensation or reimbursement by insurance or otherwise;
- Liquidation of the employee's assets;
- Cessation of elective contributions to the employee's 401(k) plan;
- Other distributions or nontaxable loans from plans maintained by the employer or a previous employer; or
- Borrowing from commercial sources at a reasonable interest rate.

If the plan administrator approves a hardship distribution, the employer must immediately stop making the employee's elective contributions to the 401(k) plan. An employee may resume elective contributions to a 401(k) plan on the first allowable entrance date at least six months after the hardship distribution. This restriction on resuming elective contributions to a 401(k) plan could result in an employee being unable to make elective contributions for up to 12 months after the hardship distribution.

The plan administrator is subject to a reporting requirement when making a hardship distribution and must issue a 1099-R to the employee, coding the distribution as a hardship distribution. A plan administrator must adhere to all applicable laws when administering the plan to avoid a failure of plan administration. If the plan administrator does not follow the applicable laws when making a hardship distribution, the IRS offers a program to bring a 401(k) plan back into compliance. However, the IRS program often requires the employee to pay back the amount of the invalid distribution, which, in itself, may create a hardship for the employee.

Before employers make any plan amendments to allow for hardship distributions or employees request them, a complete understanding of the rules is critical.