
Benefits BULLETIN

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Hardship Distributions Made Easy

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Sometimes employees need cash to pay for unexpected life events and may consider withdrawing money from their 401(k) as a hardship distribution. These distributions can be extremely helpful to the employee in their time of need, but the employer or plan administrator needs to understand the rules surrounding these transactions if they wish to stay in compliance with the regulations of the Internal Revenue Service (“IRS”) and Department of Labor (“DOL”).

First, the plan administrator should review the plan documents to identify three important items; (1) does your plan allow for hardship distributions; (2) how does your plan define a hardship; and (3) what sources of a participant’s account balance can be distributed in the case of a hardship.

The IRS defines a hardship as “an immediate and heavy financial need of the employee” – including their spouse, dependents or beneficiary. IRS guidance specifically discusses the following six expenses that would meet this definition:

1. Certain medical expenses incurred
2. Costs relating to the purchase of a principal residence
3. Tuition and related educational fees and expenses
4. Payments necessary to prevent eviction from, or foreclosure on, a principal residence.
5. Burial or funeral expenses
6. Certain expenses for the repair of damage to the employee’s principal residence.



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The IRS stresses that even if these items are met, an employee might not be eligible for a distribution if they have other resources available to meet their financial need such as a vacation home, 401(k) plan loans, assets of a spouse and minor children, etc.

Typically, plans that allow for hardship distributions use the IRS definition of a hardship. However, if a plan does not use the IRS definition, but uses alternate wording, a thorough review of the plan document needs to be performed. A plan administrator may want to consider consulting an attorney who specializes in employee benefits law to assist in understanding the plan documents as they relate to hardship distributions.

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Some plan documents clearly state the evidence a participant needs to provide to show to demonstrate a hardship, other plan documents are vague. And, while third party administrators are being utilized more frequently regarding the processing of 401(k) transactions, the plan’s trustees and administrators must not forget that they still have a fiduciary responsibility to maintain the proper documentation and related considerations regarding the hardship distribution. The IRS recommends that plan sponsors retain documentation of the review and approval of a participant’s requested hardship, financial information to substantiate the participant’s immediate and heavy financial need and proof that the distribution was

made. Some plan administrators may rely on the written representation of an employee. However, a distribution should not be made if the employer is aware of other ways the employee can relieve the financial hardship.

The plan administrator must also take into consideration the amount of the distribution requested. The withdrawal amount may not exceed the amount of the participant’s financial need or available balance that can be distributed for the hardship. In other words, if a participant needs \$5,000 to prevent a foreclosure on their principal residence, they cannot withdraw \$10,000.

Some plans allow participants to take hardship distributions of employee and employer contributions and related earnings, while others might limit the distribution to balances from employee contributions. For example, if that same participant in need of \$5,000 has an account balance comprised of \$4,000 from employee deferrals and \$1,000 from employer contributions, and is participating in a plan that does not allow hardship distributions from employer contributions, the plan would only be able to distribute \$4,000 of the \$5,000 requested.

A plan administrator’s responsibility does not end once the distribution is approved. Once a participant takes a hardship distribution, they will not be able to contribute to the plan for 6 months. The reason being that an individual facing a financial hardship would not have available funds to continue contributing to the plan. Employers need to have procedures in place to stop employee contributions once a hardship distribution occurs.

When an employee requests a hardship distribution, it is the plan administrator’s responsibility to determine that the hardship distribution is carried out in compliance with regulations set by the IRS and DOL. If a hardship distribution is not approved in compliance with the plan document or IRS regulations, the plan should take immediate action to correct the situation, as the plan could risk being disqualified.

A plan administrator may want to develop an internal checklist to address these items and document the review of an employee's request for a hardship distribution. If the approval process is being handled by a third party administrator, consider having a second review or approval by the plan administrator as well. Being proactive by having a strong understanding of this process and maintaining proper documentation will help fulfill the fiduciary responsibility of the plan administrator and employer and maintain the plan's tax status.

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