Hardship Distribution Guide for Plan Sponsors

(This piece outlines the basic IRS Safe Harbor rules for Hardship distributions from 401(k) Plan accounts)

What are permissible Hardship expenses?

1. **Medical Expenses –** that would otherwise be deductible under IRC §213(d) for the Participant, the Participant's spouse, or the Participant's dependents (not including the 7.5% of AGI limit). The definition of medical expenses is broad and includes dental work. However, purely cosmetic surgery is not included.
2. **Purchase of a Primary Residence –** for the Participant. Purchase of a beach house or renovation of a principal residence does not count.
3. **Post-Secondary Education Expenses –** including tuition, educational fees, or room and board expenses for the next 12 months for the Participant, spouse, or dependents. High school is not post-secondary.
4. **Payments to Prevent Eviction or Foreclosure –** from/on the Participant's principal residence. This does not include simply being late on mortgage payments, but requires the threat of, or actual, legal proceedings.
5. **Funeral or Burial Expenses –** for the Participant's deceased parent, spouse, children, or dependents.
6. **Casualty Expenses –** for the repair of damage to the Participant's principal residence that would otherwise qualify for the casualty deduction under IRC §165. This can cover expenses such as plumbing repairs and roof damage if it was not the result of normal wear and tear.

Does the Participant have to exhaust other distribution options first, such as loans?

Generally - YES. If a Participant is eligible for a Plan Loan, the loan option must be used before taking a Hardship distribution. There are some exceptions to this rule, most notably if the loan itself will exacerbate the hardship conditions of the Participant.

What amount can be taken as a Hardship distribution?

Only the amount that is needed to satisfy the Hardship can be withdrawn. However, grossing up the Hardship amount for anticipated taxes is permitted. This is important as the Hardship distribution itself is subject to ordinary income tax to the Participant **and** subject to a 10% penalty if the Participant is under 59 ½ years old. In addition, for 401(k) Hardship distributions, only the principal amount of the Participant's 401(k) contributions minus prior Hardship distributions can be withdrawn – not the earnings (there is a special exception for pre-1989 earnings).

The 6 Month Contribution Suspension Rule

If a Participant takes a Hardship distribution, then the IRS Regulations require that the employer stop 401(k) payroll withholdings for that Participant for a period of 6 months following the date of the Hardship distribution. After the 6 month period, you should resume the Participants normal 401(k) contributions.

What is the Employer's responsibility?

The Employer, as a Fiduciary to the Plan, is responsible for ensuring that these rules are followed. Failure to follow them and/or an inability to demonstrate that they were followed (ie: documentation/substantiation) can result in the disqualification of your Plan. Don't sign off on a distribution request if these rules have not been followed and insist on substantiation documentation relating to the claimed hardship.

NOTE: This piece is an overview only. Hardship distribution rules are complex and this is intended as a basic introduction.

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