UNDERSTANDING HARDSHIP DISTRIBUTIONS

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Retirement plans are established by employers to provide a means for employees to save for their retirement. The IRS approves plans that meet certain guidelines, and these qualified plans provide tax incentives for employers and their participating employees. To achieve their designated purpose for retirement savings, retirement plans are designed to limit the circumstances for withdrawals.

Generally, distributions can occur when a participant terminates employment, becomes disabled, dies, or reaches the age of 59 1/2. Additionally, retirement plans can, but are not required to provide for hardship distributions for active employees who are under the age of 59 1/2. The plan document is required to identify the specific types of distributions allowed by the plan.

Hardship distributions are allowed in 401(k) and 403(b) plans only when specific criteria are met. The IRS specifies that the distribution is required to satisfy a financial need that is characterized as "immediate and heavy". The following expenses are deemed to be immediate and heavy by the IRS:

- Medical expenses
- Purchase of a principal residence (excluding mortgage payments)
- Repair damage to a principal residence
- Payments to stop eviction from a principal residence
- Funeral and burial expenses
- Tuition and related educational fees

For a plan to allow for hardship distributions, the plan document must specifically describe the type of hardship distributions that are allowed by the plan, but may exclude other items deemed immediate and heavy by the IRS. The plan document must also identify the specific funds available for hardship distributions. Such distributions can be limited to the employee’s total elective contributions and Roth contributions, or can also be available from vested employer matching and profit-sharing contributions, if specified in the plan document.

Distributions are not deemed to be immediate and heavy if the plan participant has other resources available to pay for the expense. Therefore, before a participant is eligible to receive a hardship distribution, the participant must first obtain all available distributions and loans allowed under the plan and any other plans maintained by the employer. The amount and availability of the participant’s personal resources and those of the spouse and minor children should also be considered in the determination, as well as anticipated insurance reimbursements, etc. If the loans and other available distributions and personal resources do not satisfy the employee’s hardship, then a hardship distribution for the uncovered portion can be considered.
In addition to the penalties and income taxes imposed, there are other consequences to the participant when taking a hardship distribution. The participant is prohibited from making contributions into the plan for a period of six months after the distribution. Hardship distributions cannot be repaid to the plan, and, as such, the distribution permanently reduces the participant’s account balance.

The amount of the hardship distribution may not exceed the amount needed to cover the cost of the hardship plus taxes and penalties resulting from the distribution. A written request form and supporting documentation must be provided to the plan sponsor and/or to the plan administrator, whomever has the authority and responsibility to approve such transactions. Examples of supporting documentation can include, but are not limited to copies of bills or notices received by the participant and/or documentation of an impending or foreseeable hardship. Determinations of hardship are generally made on the basis of relevant facts and circumstances. The plan sponsor or plan administrator can rely on written representation as to the availability of the participant’s personal resources to satisfy the hardship, unless they have knowledge to the contrary.

Once approved, a hardship distribution can be processed, and the withdrawal, net of taxes withheld, can be provided to the participant. Unless the distribution comes from Roth contributions, hardship distributions are taxed as ordinary income on the participant’s personal federal income tax returns, and if the participant is under the age of 59 1/2 at the time of distribution, the participant will also be subject to a 10% penalty on their federal income tax return. Additionally, hardship distributions may be subject to state income taxes.

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