Hardship Distributions

- Optional under terms of plan document
- Plan may use “facts and circumstances” or “safe harbor” reasons
- Must be immediate and heavy financial need
- 401(k) regulations - §1.401(k) – 1(d)(3)
Hardship Distributions

- Amount may not exceed amount needed to satisfy hardship
  - But may be trued up for taxes and penalties

Safe Harbor definitions:
- Medical care deductible under Tax Code §213(d)
- Purchase of principal residence (excluding mortgage payments)
- Post-secondary education (next 12 months)
- Prevent eviction or foreclosure from principal residence
- Funeral expenses
- Casualty deduction home repairs
Hardship Distributions

- Principal residence
  - IRS has opined:
    - Purchase of residence for family members but NOT the employee would not be allowed
    - Purchase of house from an ex-spouse would be allowed
  - These opinions were expressed at industry functions and are not part of the regulations

Hardship Distributions

- Beneficiaries who incur hardship may qualify
  - Must be primary beneficiary
  - Must be at time that the hardship occurred (cannot change beneficiary designation after the hardship)
  - Applies to medical, education, funeral expenses
Hardship Distributions

• Suspension of deferrals may apply
  – Plans that use “safe harbor”
  – Must be six months for Safe Harbor match plans
  – May be up to 12 months for other plans
    • Always see the plan document for verification
  – Plans that use “facts and circumstances” do not have to require a suspension

• Note: Proposed Bill – “SEAL Act” would eliminate the suspension

Hardship Distributions

– Proof of hardship
  • Not defined in regulations
  • 2008 ASPPA Annual conference IRS stated that Plan Administrator must have “sufficient information to adjudicate a claim – see regulations relating to Katrina”
  • My advice – paperwork now can save a lot of hassle after the fact if an audit or questions occur
Record Retention

• Employee Plans Newsletter – 2015-4
• It is the employer’s responsibility to maintain records
• IRS has found under audit that employer may not have these

Record Retention

• Employee Plans Newsletter – 2015-4
• Per the newsletter – electronic self certification is not adequate
Per The Newsletter

The plan sponsor should retain these records in paper or electronic format:

- Documentation of the hardship request, review and approval;
- Financial information and documentation that substantiates the employee’s immediate and heavy financial need;
- Documentation to support that the hardship distribution was properly made in accordance with the applicable plan provisions and the Internal Revenue Code; and
- Proof of the actual distribution made and related Forms 1099-R.

Hardship Distributions

– Does an immediate and heavy financial need exist?

  • For this part of the process a plan administrator may rely on the representations of the employee (and not demand proof)

    – Unless “knowledge to the contrary”
Hardship Distributions

– Rules require that all other distributions and nontaxable loans from all plans of same employer be taken first

• This does not mean that all plans must have a loan provision

Hardship Distributions

– Loan does not have to be taken if it will be “Counterproductive”

• If it will increase hardship such as preventing a third party loan (mortgage for primary residence) or take home pay would be lowered too much

• There is no criteria in regulations for this
  – Documentation should be kept
If You Are the 3(16) Plan Administrator

– It will be your fiduciary responsibility to make sure that the distribution is permissible under the IRS regulations
– Record retention
– How well can you say “no”
– A NAPA survey in August found that “it’s my money and why can’t I have it” is one of the most frustrating questions from participants

Question

– What is your procedure on takeover plans when it comes to the breakdown between earnings and deferrals

– Remember: earnings associated with deferrals are not eligible for distribution
Limitation

– Distributions are limited to the elective deferral amount NOT including earnings

– For subsequent hardships the deferral total is reduced by the TOTAL first withdrawal (no proration of earnings)

Hardship Distributions – What to do?????

- Participant is 5 months behind in mortgage payments
- Receives letter threatening foreclosure
- Needs $5,000 for late payments, legal fees and bank fees associated with foreclosure

- Real estate taxes of $1,800 are due next month
- Can’t make next two payments totaling $1,200

- Question: Can he take one hardship instead of three (to save on distribution expenses)
Hardship Distributions

- Plan Administrator needs to consider:
  - The 12 month in advance rule that applies to tuition does not apply to other hardship reasons
  - No specific IRS guidance on this matter
  - If you allow two months – where is the line drawn, at three, four, twelve?
  - Need to look at the immediate and heavy financial need. If Plan Administrator is comfortable that documentation will be sufficient in an audit situation
  - Bob’s caution – if the foreclosure has not been threatened because of the taxes and future payments the criteria may not be satisfied. How threatening is the letter about future payments?

Questions