Administering Hardship Distributions Should Not Be a Hardship

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According to a survey on Bankrate.com [https://www.bankrate.com/banking/savings/financial-security-january-2019], 60 percent of Americans do not have sufficient funds saved to enable them to pay for an unexpected emergency expense. The failure to save money is at epidemic levels.

One way that an individual can deal with desperate circumstances (or more-than-normal financial needs, in some circumstances) is to use his or her retirement savings. The Internal Revenue Code (the “Code”) permits distributions from retirement plans in limited circumstances due to hardship.

Beth, a participant in her employer’s plan, goes to Meg, the Director of HR, requesting access to her retirement savings to cover unexpected medical expenses. Meg, having heard of hardship distributions at a conference last year, approves the distribution. The plan year ends and you, the third-party administrator (“TPA”), request data from Meg to complete the annual testing and filings. As part of this process, Meg reports the hardship distribution to you. You, of course, know that this plan does not allow for hardship distributions and immediately call Meg to discuss. Even though Meg had Beth provide appropriate substantiation for the hardship and only distributed enough to cover the medical expenses, because hardship distributions are not allowed from the plan, money has left the plan in error. You know this is an operational failure that puts the plan’s compliance at risk, but how do you correct it?

What is a hardship?

Hardship distributions are available from profit sharing plans and stock bonus plans, and may be paid from employer contribution accounts, as well as from 401(k)-type funds (i.e., employee salary deferrals, qualified nonelective contributions, and safe harbor contributions), if the plan so permits. The rules for 401(k)-type distributions are more stringent than those for distributions of the employer-contributed funds. As a result, even if a plan permits hardship distributions of non-401(k)-type funds, the plan often uses the 401(k) rules for all distributions. Those are the rules that will be discussed here.

To qualify to take a hardship distribution, the employee must be suffering an immediate and heavy financial need. The Code permits the Plan Administrator (usually the employer or the plan committee) to evaluate each participant's situation on a case-by-case basis to determine whether it qualifies. The Treasury Regulations provide for a "safe harbor" listing of events, all of which are deemed to meet the Code's requirements, which makes the process of determining qualification easier for the Plan Administrator. As a result, most plans limit the qualifying events for a hardship distribution to this list:

1. Medical expenses for the participant, spouse, children, dependents, or his or her primary beneficiary that would be considered to be deductible under Code section 213(d) (disregarding the requirement that they exceed 7.5% of adjusted gross income);
2. Costs relating to the purchase of the participant's principal residence (excluding mortgage payments);
3. Tuition and related educational fees and room and board expenses for up to the next 12 months of post-secondary education for the participant or his or her spouse, children, dependents, or designated beneficiary;
4. Payments necessary to prevent the participant's eviction from, or foreclosure on, his or her principal residence;
5. Burial or funeral expenses for the participant's deceased parent, spouse, child, dependent, or primary beneficiary;
6. Expenses for the repair of damage to the participant's principal residence that would qualify for the casualty deduction under Code section 165 (disregarding the requirement that the damage was caused by a federally declared disaster); and
7. Expenses and losses (including loss of income) incurred by the participant on account of a federally-declared (i.e., by the Federal Emergency Management Agency (FEMA)) disaster, if the participant's principal residence or place of employment was in the area designated by FEMA for individual assistance with respect to the disaster.

As not every plan provides for the use of the safe harbor, and not all plans allow distributions under all of these events (particularly the 6th and 7th items on the list, which are relatively new additions to the rules), it is important to read the plan document before permitting the distribution. Although Beth's medical expenses would be an appropriate hardship under the safe harbor list, because the plan document does not allow for hardship distributions, the distribution was improper.

How much may be distributed to the participant?

Once a participant has shown that a heavy and immediate need exists, the Treasury Regulations provide that the amount of the distribution cannot exceed what the participant requires to satisfy the need, including taxes and penalties. Therefore, the distribution can cover the costs associated with the need, and also may be "grossed up" so that there is enough available after income taxes (and, if the participant is not yet age 59½, the 10 percent early withdrawal tax) to pay for the hardship. Of course, the amount of the distribution cannot exceed the participant's account (or the part of the participant's account that the plan permits to be distributed on hardship).

The Regulations also provide that the participant cannot qualify for a hardship distribution if he or she can pay for the hardship with other funds. As with the determination of whether a hardship exists, the Regulations permit the Plan Administrator to review the participant's financial situation to determine what other resources are available to him or her for the need, such as insurance, other assets, available loans, or credit. In some circumstances, the Regulations permit the Plan Administrator to rely on the participant's representation as to his or her financial situation, unless the Plan Administrator has knowledge to the contrary.

However, the Regulations also permit a short-cut method to show that this "necessary to satisfy the need" requirement is met, without obligating the Plan Administrator to examine the participant's financial condition. Under this safe harbor, the distribution is deemed to be necessary to satisfy the participant's demonstrated need if the participant simply takes any otherwise available distributions from the plan making the hardship distribution or from any other plan sponsored by the employer. (In years before 2020, it is possible that the plan will also require that the participant suspend making salary deferral contributions to the plan making the distribution, and any other qualified or nonqualified plan, for six months. This restriction is no longer permitted as of January 1, 2020. Plans could elect to eliminate this rule before then. The plan must be amended to remove the deferral suspension requirement by the due date of the employer's tax return for the year in which the amendment is effective.)

What proof must the plan obtain and retain in relation to the hardship distribution?

Historically, the Plan Administrator could not rely on the participant's representation that he or she had suffered a hardship event or the amount of the hardship. Therefore, the Plan Administrator required the participant to submit proof of an event's occurrence and the amount of money needed (such as medical, tuition, or home repair bills). Plans may still require this type of information.

However, the IRS has issued guidance that provides for an alternate method of compliance with these rules. Under this guidance, two steps are required. First, the Plan Administrator must provide the employee requesting the hardship distribution with information about the taxability of the distribution, the legal limitations on the amount permitted to be distributed, and the need to retain source documents to substantiate the hardship need and amount. Second, the participant must provide the Plan Administrator with a summary of the hardship event and expenses and certify that the provided information is true and accurate. (See Ferenczy FlashPoint for more information: https://ferenczylaw.com/flashpoint-fiduciary-rules-and-401k-hardship-distributions-the-latest/)

How do you correct for an improper hardship distribution?

Thanks to the updated self-correction procedures established in Revenue Procedure 2019-19, the current Employee Plans Compliance Resolution System ("EPCRS"), Plan Sponsors have new options for correcting the error of making a hardship distribution when the plan did not contain a hardship provision. Section 4.05 of the Revenue Procedure gives Plan Sponsors the ability to correct a plan by a retroactive plan amendment so long as: (1) the amendment would result in an increase of a benefit, right, or feature; (2) the increase applies to all employees eligible to participate in the plan; and (3) providing the increase is permitted under the other requirements of the Code and EPCRS (meaning the correction cannot create new failures or tax issues).

How would this work for Beth? Because Beth had a legitimate hardship and received only the amount necessary to cover her financial need (grossed up for applicable taxes), the only failure is that the plan terms were not followed. If the plan can adopt an amendment that is retroactively effective to allow hardship distributions, the failure is corrected. We already know that Meg thought the plan allowed for hardship distributions. If she has been approving all prior hardship distributions on a nondiscriminatory basis, meaning she has not favored Highly Compensated Employees, the plan likely qualifies for self-correction by amendment. Meg should have her TPA prepare the necessary amendment and document the reasons she believes the amendment satisfies the three conditions listed above.

The correction changes if the distribution made was not for an appropriate hardship. Suppose Beth requested a hardship distribution without actually having a hardship event, and Meg approved it. In that case, there was no valid distribution from the plan, because there was no distributable event. Furthermore, in-service distributions are generally impermissible from a 401(k) plan in absence of a hardship or attainment of age 59½.

A plan amendment cannot correct a distribution that was in violation of the law. In this case, the distribution would be treated as an overpayment under Section 6.06(4) of EPCRS, as the participant received a distribution in the absence of a distributable event. Meg must ask Beth to return the money to the plan. If Beth returns the money, the failure is corrected. Luckily for Meg, if Beth refuses to return the money, the failure is still corrected. Under Section 6.06(4), a Plan Sponsor does not need to fund a "make-whole contribution" to the plan if the failure arose solely because payment was made in the absence of a distributable event but was otherwise determined in accordance with the terms of the plan.

Last but not least, the Plan Administrator is required to have reasonable policies and procedures designed to properly administer the Plan. It would be prudent for Meg to tighten up her procedures to make sure that she does not approve any further improper distributions.

Conclusion

Here are some suggestions to help you assist your clients in complying with the hardship rules:

- Make sure your clients understand the procedures for hardships;
- Always check your client's plan document before you process a hardship distribution to be sure that you follow that plan's rules;
- Develop and provide your clients with a "substantiation package" to conform to the notice and certification requirements to enable the participant to request a hardship distribution and to provide the needed summary and retain the necessary source materials (we can help you with this if you need assistance);
- If you provide plan documentation to your clients, make sure you are set up to provide your clients with the amendment to remove the deferral suspension requirement before the due date (and to make sure that the permitted hardship events match the latest rules); and
- Make sure that someone is properly preparing Forms 1099-R for hardship distributions and that the form provides that the distribution is not eligible for rollover.

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