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Hardship Withdrawals Create Hardships for Plan Sponsors

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To avoid a "facts and circumstances" review before approving a hardship distribution, many plan sponsors and third-party administrators restrict the allowable reasons for a hardship distribution to the six safe harbor expenses expressly listed in the applicable regulations. However, the safe harbor rules to avoid a facts and circumstances review of a hardship request include more than simply restricting the allowable hardship distribution reasons.

INTRODUCTION

Many plan sponsors and third-party administrators describe the hardship distribution safe harbor as if there is only one part to the two-part safe harbor rules. Everyone seems to understand the safe harbor rules for a hardship withdrawal to be deemed *on account of* an immediate and heavy financial need of the employee (*i.e.*, the safe harbor reasons for a hardship distribution).[1] However, there is a second part to safe harbor rules for the hardship withdrawal to be deemed *necessary to satisfy* an immediate and heavy financial need of the employee that many plan sponsors and third-party administrators do not seem to fully recognize.[2] Unless both parts of the safe harbor are satisfied, there is generally a "facts and circumstances" determination for the plan sponsor or third-party administrator to satisfy before permitting a valid hardship withdrawal.[3]

Regardless of whether a plan uses the hardship safe harbors, the determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.[4] Errors involving hardship distributions are among the top ten compliance issues found by the Employee Plans Team Audit Program of the IRS.[5] Nevertheless, hardship withdrawals are a common plan feature. Among 328 employers with defined contribution plans surveyed in 2015, 96 percent permitted hardship withdrawals and, over the biennial survey results since 2001, the percentage has never been less than 91 percent.[6]

HARDSHIP WITHDRAWAL SAFE HARBOR REASONS

Applicable regulations under Internal Revenue Code (Code) Sections 401(k) and 403(b) generally provide that the determination of whether an employee has an immediate and heavy financial need that would permit a hardship withdrawal must be based on all the relevant facts and circumstances.[7] However, the regulations state that the following expenses are *deemed* to be for an immediate and heavy financial need (*i.e.*, are safe harbor expenses):[8]

1. Expenses for (or necessary to obtain) medical care that would be deductible under Code Section 213(d) (determined without regard to whether the expenses exceed 7.5 percent of adjusted gross income);

2. Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

3. Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in Section Code 152, and, for taxable years beginning on or after January 1, 2005, without regard to Code Sections 152(b)(1), (b)(2) and (d)(1)(B));

4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

5. Payments for burial or funeral expenses for the employee's deceased parent, spouse, children, or dependents (as defined in Code Section 152, and, for taxable years

beginning on or after January 1, 2005, without regard to Code Section 152(d)(1)(B)); or

6. Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Code Section 165 (determined without regard to whether the loss exceeds 10 percent of adjusted gross income).

Most plan sponsors and third-party administrators are well aware of the above safe harbor *reasons* for allowing a hardship withdrawal from a 401(k) or 403(b) plan.[9] Most limit the expenses eligible for a hardship distribution to the six listed above, although some plan documents also allow for other expenses to be considered for hardship, in which case a facts and circumstances determination for such expenses would be required.[10] If a hardship withdrawal is on account of one of the above six safe harbor reasons, there need not be a facts and circumstances determination of whether the employee has an immediate and heavy financial need for a hardship withdrawal. However, there is still the separate question of whether the hardship withdrawal is *necessary* to satisfy an immediate and heavy financial need.[11]

HARDSHIP WITHDRAWAL NECESSITY SAFE HARBOR

A hardship withdrawal is treated as *necessary* to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the hardship withdrawal is not in excess of the amount required to satisfy the financial need. The amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the hardship withdrawal.[12] Nevertheless, a hardship withdrawal is not treated as *necessary* to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee, and this determination generally is to be made on the basis of all the relevant facts and circumstances.[13]

However, a hardship distribution is *deemed* necessary to satisfy an immediate and heavy financial need of an employee (*i.e.*, is a safe harbor necessity), if each of the following requirements is satisfied:[14]

1. The employee has obtained all other currently available distributions (including distribution of employee stock ownership

plan (ESOP) dividends under Code Section 404(k), but not hardship distributions) and nontaxable (at the time of the loan) loans, under the plan and all other plans maintained by the employer; and

2. The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions[15] and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution.

Failure to satisfy the hardship withdrawal necessity safe harbor requirements does not automatically mean that the hardship withdrawal is invalid. But it does generally mean that the determination of the extent to which the immediate and heavy financial need of the participant cannot be relieved from other sources reasonably available to the participant must be made on the basis of all the relevant facts and circumstances.[16]

A frequently overlooked requirement of the necessity component of the hardship withdrawal safe harbor is that "all other plans maintained by the employer" means all qualified *and nonqualified* plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan within the meaning of Code Section 125, but not including the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan (including one that is part of a cafeteria plan).[17]

Cessation of Contributions to Nonqualified Plans

Some plan sponsors, or their third-party administrators, intending to satisfy the hardship withdrawal safe harbor rules, do not suspend elective contributions and employee contributions to nonqualified plans of the employer when a participant takes a hardship distribution. Rather, they only suspend for six months the elective contributions and employee contributions of the participant to the plan from which the hardship withdrawal is taken and, perhaps, other qualified plans of the employer. Although such an approach may satisfy a facts and circumstances determination, it does not seem to satisfy the safe harbor requirements. In many instances, the third-party administrators are not even aware of an employer's nonqualified plans or it is extremely difficult to coordinate hardship administration with the nonqualified plans. If the third-party administrator or another party is administering hardship distributions for the plan sponsor, this portion of the hardship safe harbor rules requires coordination between the plan sponsor and the third-party administrator or other party.

Procurement of Plan Loans

Another portion of the necessity safe harbor requirements that is sometimes overlooked is the requirement that the participant taking a hardship withdrawal has obtained all currently available nontaxable loans from the plan and all other plans maintained by the employer.[18] Some plan documents include language regarding suspending elective contributions and employee contributions (discussed in the prior paragraph), but do not include language requiring that all currently available nontaxable loans from the plan and all other plans maintained by the employer be obtained by the employee.[19] Such language does not seem to satisfy the safe harbor requirements, although a hardship request may still satisfy a facts and circumstances determination as to the extent participant's need may be relieved from other resources reasonably available to the participant.[20] It seems that some third-party administrators have difficulties with this safe harbor requirement, particularly with respect to 403(b) plans when there are multiple record keepers.

SELF-CERTIFICATION

As an alternative to the hardship withdrawal necessity safe harbor described above, an employer may rely on an employee's representation that an immediate and heavy financial need is not capable of being relieved from other resources reasonably available to the employee, provided that the representation is in writing and the employer does not have actual knowledge to the contrary of the employee's representation.[21] The employee must represent that the need cannot be relieved:

1. Through reimbursement or compensation by insurance or otherwise;

2. By liquidation of the employee's assets;

3. By cessation of elective contributions or employee contributions under the plan;

4. By other currently available distributions (including distribution of ESOP dividends under Code Section 404(k)) and nontaxable

(at the time of the loan) loans, under plans maintained by the employer or by any other employer; or

5. By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

However, an employee need not take counterproductive actions. An employee's need cannot reasonably be relieved by one of the five actions above, if the result would be to increase the amount of the employee's need. For example, a need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing for the purchase.[22]

Note that the self-certification alternative does not require that elective contributions and employee contributions to the plan and all other plans maintained by the employer cease for at least six months after receipt of the hardship distribution. Nevertheless, many plans that rely on self-certification require the six-month suspension anyway. Some plans are expressly drafted to use self-certification in order to avoid an employee having to cease elective contributions and employee contributions.[23]

An example of self-certification is provided in the regulations. In the example, an employee requests a $10,000 distribution from the employer's plan, which does not permit loans, to pay six months of college tuition and room and board expenses for the employee's child, which is deemed to be on account of the employee's immediate and heavy financial need. The employee makes a written representation of the five points listed above, and with respect to which the employer has no actual knowledge to the contrary, that the need cannot be reasonably relieved other than with a hardship distribution. The example concludes that, because the employer can rely on the employee's written representation, the distribution is considered necessary to satisfy the employee's immediate and heavy financial need and the employee may receive a $10,000 hardship distribution plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.[24]

The IRS has confirmed that self-certification is permitted to show that an immediate and heavy financial need is not capable of being relieved from other resources reasonably available to the employee, but self-certification is not sufficient documentation to demonstrate the reason for the hardship distribution. Further, even if the employer uses a third-party administrator to handle hardship distributions, the employer is ultimately responsible for the proper administration of the plan.[25]

Whether self-certification is used or not, the IRS has stated that an employer must keep hardship distribution records and should retain the following records in paper or electronic format so they are available in an IRS audit:

1. Documentation of the hardship request, review, and approval;

2. Financial information and documentation that substantiates the employee's immediate and heavy financial need;

3. Documentation to support that the hardship distribution was properly made in accordance with the applicable plan provisions and the Internal Revenue Code; and

4. Proof of the actual distribution made and related Forms 1099-R.

According to informal guidance from the IRS, failing to have these records available for examination is a qualification failure that should be corrected using the Employee Plans Compliance Resolution System (EPCRS).[26]

CONCLUSION

The primary purpose of retirement plans is to provide employees with retirement income. Some employers may view the hardship withdrawal feature as a "safety valve," necessary to induce employees to save for retirement in the employer's defined contribution plan. Under this view, without the availability of a hardship withdrawal, employees will forego contributing to the retirement plan for fear of otherwise needing the funds. For instance, more than 55 percent of the reasons reported for a hardship withdrawal in 2015 was to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.[27] Perhaps many participants taking those hardship withdrawals would have contributed less to the plan without the availability of a hardship withdrawal. On the other hand, the average and median account balances at the end of 2015, as shown in the two charts below, suggest that employers may want to consider doing more to help employees keep funds in their retirement plans[28] and, perhaps, provide education and counseling on budgeting, saving for unexpected expenses and emergencies, and what constitutes a reasonable expenditure on housing costs.

Average Plan Balance by Age at End of 2015	
20–29	$10,940
30–39	$44,520
40–49	$98,510
50–59	$161,690
60+	$141,610
Median Plan Balance by Age at End of 2015	
20–29	$3,886
30–39	$18,036
40–49	$38,997
50–59	$64,602
60+	$42,310

The differences in average and median balances indicate the average balances are upwardly influenced by some high savers, because the median balances are the balances of those with half of the age group having higher balances and half of the age group having lower balances.

Among 313 employers with defined contribution plans that permit hardship distributions surveyed in 2015, 81 percent determined eligibility for hardship withdrawals based on the safe harbor rules, and, over the biennial survey results since 2007, the percentage has never been less than 81 percent.[29] Given the complexity, and possibly widespread misunderstanding, of the hardship distribution safe harbor rules and the IRS's apparent focus on hardship distribution compliance errors, whether under the safe harbor rules or not, plan sponsors may want to consider whether they want to offer, or continue to offer, a hardship withdrawal feature in their 401(k) or 403(b) plans. There is often a tension between an employer's desire to have hardship determinations made by someone else and a third-party administrator's willingness to make hardship determinations. Those plan sponsors who wish to provide a hardship withdrawal feature should carefully review their hardship withdrawal processes and documentation with their third-party administrators and other plan advisors, particularly if they are relying on the hardship distribution safe harbor rules.

NOTES

1. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iii)(B) and 1.403(b)-6(d)(2).
2. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(E) and 1.403(b)-6(d)(2).
3. Note that certain Internal Revenue Code (Code) Section 401(k) and 403(b) plan contributions are not even eligible for a hardship distribution, regardless of whether the hardship safe harbor

rules apply or not, such as contributions necessary to satisfy a plan's actual deferral percentage (ADP) or actual contribution percentage (ACP) safe harbor, or employer contributions to a custodial account of a 403(b) plan even if such contributions are later transferred to an annuity contract of the 403(b) plan. *See, e.g.,* D. Schwallie, Lesser Known Differences Between 403(b) and 401(k) Plans, 20 *Journal of Deferred Compensation* 6 (2015) and D. Schwallie, Nuanced APD/ACP Safe Harbor Plan Design, 40 *Journal of Pension Planning & Compliance* 1 (2014).

4. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(i) and 1.403(b)-6(d)(2).
5. *See* Top Ten Issues Found in EPTA Audits: *https://www.irs.gov/retirement-plans/ep-team-audit-epta-program-top-ten-issues-found-in-epta-audits.*
6. Source: Aon Hewitt, *2015 Trends & Experience in Defined Contribution Plans* report.
7. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iii)(A) and 1.403(b)-6(d)(2).
8. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iii)(B) and 1.403(b)-6(d)(2). IRS Notice 2007-7 modified the hardship distribution rules for 401(k) and 403(b) plans (in accordance with Section 826 of the Pension Protection Act of 2006) to permit (but not require) such plans to treat a participant's beneficiary under the plan the same as the participant's spouse or dependent in determining whether the participant has incurred a hardship. Q&A-5(A) of the notice states: A § 401(k) plan that permits hardship distributions of elective contributions to a participant only for expenses described in § 1.401(k)-1(d)(3)(iii)(B) may, beginning August 17, 2006, permit distributions for expenses described in § 1.401(k)-1(d)(3)(iii)(B)(1), (3), or (5) (relating to medical, tuition, and funeral expenses, respectively) for a primary beneficiary under the plan. For this purpose, a "primary beneficiary under the plan" is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant. A plan that adopts these expanded hardship provisions must still satisfy all the other requirements applicable to hardship distributions, such as the requirement that the distribution be necessary to satisfy the financial need. These rules also apply to § 403(b) plans.
9. This article does not address distributions from a 457(b) plan or a plan subject to Code § 409A on account of an unforeseeable emergency, as the standards are different than for a hardship distribution from a 401(k) or 403(b) plan. *See, e.g.,* D. Schwallie, The Split Personalities of 457(b) Nonqualified Plans, 18 *Journal of Deferred Compensation* 36 (2013).
10. The IRS has indicated that, if plan language allows hardship distributions only under specific circumstances, then the plan cannot be more liberal in its operation. For example, although the law permits hardships for funeral expenses, a plan cannot distribute funds for funeral expenses unless the plan has payment of funeral expenses as a stated hardship. *See* Hardship Distribution Tips from EP Exam: *https://www.irs.gov/retirement-plans/hardship-distribution-tips-from-ep-exam.*
11. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv) and 1.403(b)-6(d)(2).
12. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(A) and 1.403(b)-6(d)(2).
13. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(B) and 1.403(b)-6(d)(2).
14. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(E) and 1.403(b)-6(d)(2).
15. "Elective contributions" are defined as employer contributions made to a plan pursuant to a cash or deferred election under a cash or deferred arrangement (whether or not the

arrangement is a qualified cash or deferred arrangement under Code § 1.401(k)-1(a)(4)). *See* Treas. Reg. § 1.401(k)-6.

16. Example 3 of Treas. Reg. § 1.401(k)-1(d)(6) describes the situation of an employee who requests a $15,000 hardship distribution to pay 6 months of college tuition and room and board expense for a dependent, which is a safe harbor hardship reason. At the time of the request, the sole assets reasonably available to the employee are in a savings account with an available balance of $10,000. The employer's only plan does not provide for loans. Although not explicitly stated, apparently the plan does not rely on either the employee self-certification described in the next section of this article nor the necessity safe harbor, but rather upon facts and circumstances. The example concludes that the employee may receive a distribution of only $5,000 (the $15,000 request minus the $10,000 savings account balance), plus an amount necessary to pay any federal, state, or local income tax or penalties reasonably anticipated to result from the distribution. It is not clear from the example whether or how the savings account funds were a fact or circumstance available for the determination of the extent to which resources were available other than the hardship distribution to satisfy the immediate and heavy financial need.
17. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(F) and 1.403(b)-6(d)(2). Note that nonqualified plans would include 457(b) and 457(f) plans of 501(c)(3) tax-exempt organizations and state or local governmental entities. *See, e.g.,* D. Schwallie, The Split Personalities of 457(b) Nonqualified Plans, 18 *Journal of Deferred Compensation* 36 (2013).
18. Although loans from a governmental 457(b) plan are permitted, loans from 457(b) plans of Code Section 501(c)(3) organizations are not. *See, e.g.,* D. Schwallie, Plan Loans−Whose Money Is It Anyway and Why Should You Care?, 42 *Journal of Pension Planning & Compliance* 1 (2016). A loan from a plan subject to Code Section 409A, including a 457(f) plan, may result in a prohibited acceleration of payment of deferred compensation from the plan. *See* Code § 1.409A-3(f).
19. In one recent experience, a third-party administrator requested that safe harbor language, which required that a participant has obtained all currently available nontaxable loans under the plan and all other plans maintained by the employer prior to a hardship distribution, be removed from a 403(b) plan document, yet offered no other process to determine whether a hardship distribution is necessary to satisfy an immediate and heavy financial need of the participant.
20. An "employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee." Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(B).
21. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(C) and 1.403(b)-6(d)(2). *See also* Q&A-3 of the IRS's Retirement Plans FAQs regarding Hardship Distributions: *https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-hardship-distributions.*
22. *See* Treas. Reg. §§ 1.401(k)-1(d)(3)(iv)(D) and 1.403(b)-6(d)(2).

23. It is the author's view that requiring suspension of elective contributions and employee contributions for at least 6 months after receipt of a distribution to remediate an immediate hardship is punitive and not consistent with the purported goal of 401(k) and 403(b) plans to provide a vehicle for retirement saving.
24. Treas. Reg. § 1.401(k)-1(d)(6), Example 4.
25. *See* Employee Plans News, Issue No. 2015-4 (April 1, 2015): *https://www.irs.gov/pub/irs-tege/epn_2015_4.pdf.*
26. *See* It's Up to Plan Sponsors to Track Loans, Hardship Distributions: *https://www.irs.gov/retirement-plans/its-up-to-plan-sponsors-to-track-loans-hardship-distributions.*
27. *See* Aon Hewitt, *2016 Universe Benchmarks: Employee Savings and Investing Behavior in Defined Contribution Plans* (2016), which summarizes defined contribution plan data from more than 125 plans covering roughly 3.5 million eligible participants.
28. *See, e.g.,* D. Schwallie, Plan Loans−Whose Money Is It Anyway and Why Should You Care?, 42 *Journal of Pension Planning & Compliance* 1 (2016).
29. Source: Aon Hewitt, *2015 Trends & Experience in Defined Contribution Plans* report.