

## FAQs REGARDING HARDSHIP DISTRIBUTIONS

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

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### **1. Under what circumstances can a participant get a hardship distribution from a retirement plan?**

A retirement plan may, but is not required to, provide for hardship distributions. Many plans that provide for elective deferrals provide for hardship distributions. Thus, 401(k) plans, 403(b) plans, and 457(b) plans may permit hardship distributions.

If a 401(k) plan provides for hardship distributions, it must provide the specific criteria used to make the determination of hardship. Thus, for example, a plan may provide that a distribution can be made only for medical or funeral expenses, but not for the purchase of a principal residence or for payment of tuition and education expenses. In determining the existence of a need and of the amount necessary to meet the need, the plan must specify and apply nondiscriminatory and objective standards. (Reg. §1.401(k)-1(d)(3)(i))

The rules for hardship distributions from 403(b) plans are similar to those for hardship distributions from 401(k) plans.

If a 457(b) plan provides for hardship distributions, it must contain specific language defining what constitutes a distribution on account of an "unforeseeable emergency." (Reg. § 1.457-6(c)(2))

### **2. What is the IRS definition of hardship for a 401(k) plan?**

For a distribution from a 401(k) plan to be on account of hardship, it must be made on account of an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse or dependent. (Reg. §1.401(k)-1(d)(3)(i))

Under the provisions of the Pension Protection Act of 2006, the need of the employee also may include the need of the employee's non-spouse, non-dependent beneficiary.

Whether a need is immediate and heavy depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including: (1) certain medical expenses; (2) costs relating to the purchase of a principal residence; (3) tuition and related educational fees and expenses; (4) payments necessary to prevent eviction from, or foreclosure on, a principal residence; (5) burial or funeral expenses; and (6) certain expenses for the repair of damage to the employee's principal residence. Expenses for the purchase of a boat or television would generally not qualify for a hardship distribution. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee. (Reg. §1.401(k)-1(d)(3)(iii))

A distribution is not considered necessary to satisfy an immediate and heavy financial need of an employee if the employee has other resources available to meet the need, including assets of the employee's spouse and minor children. Whether other resources are available is determined based on facts and circumstances. Thus, for example, a vacation home owned by the employee and the employee's spouse generally is considered a

resource of the employee, while property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not considered a resource of the employee. (Reg. §1.401(k)-1(d)(3)(iv)(B))

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if: (1) the employee has obtained all other currently available distributions and 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 and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution. (Reg. §1.401(k)-1(d)(3)(iv)(E))

A hardship distribution may not exceed the amount of the employee's need. However, the amount required to satisfy the financial need may include amounts necessary to pay any taxes or penalties that may result from the distribution. (Reg. §1.401(k)-1(d)(3)(iv)(A))

### **3. How does a participant show that he or she is experiencing a hardship?**

Generally, if a 401(k) plan provides for hardship distributions, the plan will specify what information must be provided to the employer to demonstrate a hardship. Most 401(k) plans use the "deemed necessary" rules described in Q&A-2 above, so that inquiry into the employee's financial status is not required. In other cases, an employer may generally rely on the employee's representation that he or she is experiencing an immediate and heavy financial need that cannot be relieved from other resources. However, an employer cannot rely on an employee's representation if the employer has actual knowledge that the employee's need can be relieved: (1) through reimbursement or compensation by insurance; (2) by liquidation of the employee's assets; (3) by stopping elective contributions or employee contributions under the plan; (4) by other currently available distributions (such as plan loans) under plans maintained by the employer or by any other employer; or (5) by borrowing from commercial sources. (Reg. §1.401(k)-1(d)(3)(iv)(C))

However, an employee is not required to take counterproductive actions. For example, the 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. (Reg. §1.401(k)-1(d)(3)(iv)(D))

### **4. What is the maximum amount of elective contributions that can be distributed as a hardship distribution from a 401(k) plan?**

The amount of elective contributions available for a hardship distribution cannot be more than the amount of the employee's total elective contributions, including designated Roth contributions, as of the date of distribution reduced by the amount of previous distributions of elective contributions. This "maximum distributable amount" generally does not include earnings, qualified nonelective contributions or qualified matching contributions, unless the plan provides that certain grandfathered amounts are included. Other amounts under the plan, if any, such as regular matching contributions and discretionary profit-sharing contributions may also be distributed on account of hardship if the plan so provides. (Reg. §1.401(k)-1(d)(3)(ii))

### **5. What are the consequences of taking a hardship distribution of elective contributions from a 401(k) plan?**

After an employee receives a hardship distribution of elective contributions from his or her 401(k) plan, generally the employee will be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the Hardship distribution. (Reg. §1.401(k)-1(d)(3)(iv)(E)(2))

Hardship distributions are includible in gross income unless they consist of designated Roth contributions. In addition, they may be subject to an additional tax on early distributions of elective contributions. Unlike loans, hardship distributions are not repaid to the plan. Thus, a hardship distribution permanently reduces the employee's account balance under the plan.

A hardship distribution cannot be rolled over into an IRA or another qualified plan. (Code § 402(c)(4))

## **6. What is a distribution on account of an unforeseeable emergency under a 457(b) plan?**

Under a 457(b) plan, a hardship distribution can only occur when the participant is faced with an unforeseeable emergency. (Code § 457(d)(1)(iii))

An unforeseeable emergency is a severe financial hardship resulting from an illness or accident, loss of property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary. Examples of events that may be considered unforeseeable emergencies include imminent foreclosure on, or eviction from, the employee's home, medical expenses, and funeral expenses. Generally, the purchase of a home and the payment of college tuition are not unforeseeable emergencies. (Reg. § 1.457-6(c)(2)(i))

Whether a participant or beneficiary is faced with an unforeseeable emergency depends on the facts and circumstances. However, a distribution is not on account of an unforeseeable emergency to the extent that the emergency can be relieved through reimbursement or compensation from insurance, liquidation of the participant's assets, or cessation of deferrals under the plan. (Reg. § 1.457-6(c)(2)(ii))

A distribution on account of an unforeseeable emergency must not exceed the amount reasonably necessary to satisfy the emergency need. (Reg. § 1.457-6(c)(2)(iii))

## **7. Are hardship distributions allowed from an IRA?**

Not exactly. There is generally no limit on when an IRA owner may take a distribution from his or her IRA, although there may be unfavorable tax consequences, such as an additional tax on early distributions. However, certain distributions from an IRA that are used for expenses similar to those that may be eligible for hardship distributions from a retirement plan are exempt from the additional tax on early distributions. Specifically, a distribution from an IRA for higher education expenses or to finance a first-time home purchase is exempt from the early distribution tax. (Code § 72(t)(2)(E),(F))