

Hardship Rules Today

Frequently Asked Questions

The hardship withdrawal rules have changed dramatically in recent years. The below FAQ addresses questions and answers based on the rules that are applicable now, in 2020.

What is a hardship distribution?

A hardship distribution is an optional triggering event a plan sponsor can make available to plan participants who are still employed. Hardship withdrawals can be permitted in profit sharing, 401(k) and 403(b) plans. They are not permitted in pension plans, like defined benefit plans and money purchase pension plans. If permitted by the plan, a participant experiencing an “immediate and heavy financial need” can take a distribution from their retirement plan balance of an amount necessary to satisfy their need. The expenses must be incurred by the participant, or in some cases the participant’s spouse, dependents, or primary beneficiary (if permitted by the plan).

In what situations is a need considered immediate and heavy?

Whether a need is immediate and heavy depends on the facts and circumstances of the situation. Many plans limit hardship withdrawals to specific reasons that are deemed to be immediate and heavy according to the regulations. By doing so, the employer does not need to review the facts and circumstances of the situation and make the decision as to whether it will qualify. For example, purchasing a boat is not an immediate and heavy financial need.

A distribution is not considered necessary to satisfy an immediate and heavy financial need if the employee has other resources available to satisfy the need. This would include the ability to take another form of distribution from the plan. A plan may require an employee to take a loan first before qualifying for a hardship distribution, but this is no longer a requirement under the final regulations.

What expenses are deemed to be immediate and heavy?

Each plan can define the rules for a participant to take a hardship withdrawal, but most plans will limit the availability of a hardship withdrawal to the following “safe harbor” reasons:

1. Medical expenses
2. Purchase of a principal residence
3. Tuition and related educational fees and expenses
4. Prevention of eviction or foreclosure
5. Burial or funeral expenses
6. Expenses to repair damage of a principal residence due to casualty loss
7. Expenses or loss incurred by a participant due to a federally declared disaster

How does the employer determine if a hardship withdrawal is necessary to satisfy a need?

The final regulations have a new standard for the employer to follow when determining if a withdrawal from the plan is necessary to satisfy a financial need.

- The withdrawal cannot exceed the amount of the need, except to cover the reasonably anticipated federal, state, or local income taxes and penalties that will apply.
- The employee must first obtain any available in-service distributions from this plan, and any other deferred compensation plan maintained by the employer.
- The employee must represent to the employer that they have insufficient cash or liquid assets “reasonably available” to satisfy their need. The regulations indicate that cash or other assets earmarked for another expense, such as rent, are not considered reasonably available.

The plan administrator may rely on the participant’s representation unless they have actual knowledge to the contrary. The plan administrator is not required to go looking for information to the contrary.

Must the plan administrator collect documentation to substantiate the expense?

Before approving a hardship distribution, the plan administrator will need to collect and review documentation that supports the request. This could be an actual invoice or other documentation reflecting the amount that must be paid, or it could be a summary of relevant information to substantiate the expense. If the plan is ever under audit, the IRS may request documentation to support a hardship distribution. The documentation must substantiate an expense that qualifies for hardship, who the expense was for, and the amount of the expense. If the plan administrator only had a summary of information to substantiate the request, and not full documentation, the participant will be required to provide this at the time of request. The plan administrator may prefer to require the full documentation up front, so they are prepared in the event of an audit.

What amounts can the participant take from the plan in the event of a hardship?

The regulations now permit any amount in a 401(k) plan to be available prior to age 59-1/2 for a hardship withdrawal, however, this may be limited by the plan document. It is not uncommon that hardship withdrawals are limited to employee elective deferral sources, but employer contributions (including safe harbor amounts) can be made available as well.

In a 403(b) plan, assets are more restricted. Earnings on elective deferrals amounts are not available. In addition, QNECs and QMACs (including safe harbor contributions) are not available from a 403(b)(7) custodial account (invested in mutual funds) but are available from a 403(b) plan that is invested in annuity contracts.

Can a participant continue to defer into the plan following a hardship withdrawal?

Yes. A deferral suspension period is no longer permitted following a hardship withdrawal. If the participant would like to continue to defer into the plan, they may do so.

Are there any consequences to the participant when they take a hardship withdrawal?

A hardship withdrawal is subject to income taxes, just like any other retirement plan distribution would be. Amounts that reflect basis, or after-tax contributions, are not taxable when distributed. However, tax withholding is not required since the distribution is not eligible for rollover treatment. 10 percent will generally be withheld, unless the participant waives this.

The participant will incur a 10 percent early distribution penalty tax if they are under age 59-1/2 and do not qualify for a penalty exception.

The participant can “gross-up” their distribution by an amount reasonably expected to cover their anticipated taxes and penalty.