401(k) Plan Fix-It Guide - Hardship distributions weren't made properly

10) Hardship distributions weren't made properly.

- **Find the Mistake**: Review all in-service distributions and determine whether hardship distributions met the plan requirements.
- **Fix the Mistake**: Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings.
- **Avoid the Mistake**: Be familiar with your plan document’s hardship provisions and ensure that you follow the provisions in operation. Ensure that your plan administrators and payroll offices share the plan’s hardship distribution information.

A 401(k) plan may allow employees to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 401(k) plan are limited to the amount of the employee’s elective deferrals. 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 on the elective contributions, qualified nonelective contributions or qualified matching contributions. Qualified nonelective contributions (QNECs) and/or qualified matching contributions are typically made to correct failed Actual Deferral Percentage (ADP) or Actual Contribution Percentage (ACP) tests. 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. The employee can’t roll over hardship distributions to another plan or IRA. The law treats a distribution as a hardship distribution only if it's made both because of an employee's immediate and heavy financial need and is limited to the amount necessary to satisfy that financial need. The employer determines whether an employee has an immediate and heavy financial need based on all relevant facts and circumstances; however, the law deems a distribution to be made because of an employee's **immediate and heavy financial need** if the distribution is for:

- Medical care expenses previously incurred by the employee, the employee’s spouse or any dependents of the employee, or if necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

https://www.irs.gov/retirement-plans/401k-plan-fix-it-guide-hardship-distributions-were-not-made-properly
• Payment of tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee, the employee’s spouse, children or dependents;
• Payments necessary to prevent the eviction of the employee from the employee’s principal residence or mortgage foreclosure on that residence;
• Funeral expenses for the employee’s deceased parent, spouse, etc.; or
• Certain expenses relating to the repair of damage to the employee’s principal residence.

In addition to demonstrating immediate and heavy financial need, the plan must also demonstrate that a distribution from the plan is necessary to address the need. 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.

For example, you may determine that the facts and circumstances for determining whether distributions from the plan are necessary to address the immediate and heavy financial need, if the employee provides you with written representation that the need cannot be adequately addressed from other sources such as:

• through reimbursement or compensation by insurance or otherwise;
• by liquidating the employee’s assets;
• by ceasing elective deferrals or employee contributions under the plan; or
• by other distributions or nontaxable loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

You may be able to rely on such representations unless you have knowledge that informs you that the representations are not correct.

A need can’t reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, a plan loan can’t reasonably relieve the need for funds to purchase a principal residence if the loan would disqualify the employee from obtaining other necessary financing.

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 six months after receipt of the hardship distribution.

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.

It’s important that you keep a record of all information used to determine whether a participant was eligible for a hardship distribution and the amount distributed was the amount necessary to alleviate the hardship. The IRS has provided some guidelines for substantiation of Safe-Harbor Hardship Distributions from 401(k) plans.

Hardship distributions may be subject to the 10% early distribution tax on distributions made prior to reaching age 59 ½.

How to find the mistake:
Review your plan document to determine if it allows hardship distributions, then review your 401(k) plan hardship procedures. If you don’t have procedures for reviewing hardship applications, establish them possibly with the help of a benefits professional.

Review all distributions made during the year and determine which may have been a hardship distribution. For each hardship distribution, make a determination whether each one met the hardship distribution requirements in the plan document. Look for abuse of the hardship feature. If most of your hardship requests come from a specific group of employees, you may have some participants abusing the hardship feature.

**How to fix the mistake:**

**Corrective action:**
If the plan document doesn’t allow for hardship distributions, but, in operation, hardship distributions do occur, correction may involve a retroactive amendment to allow hardship distributions and if hardship distributions are made to participants that don’t meet the plan document hardship requirements or the 401(k) rules, then correction may involve a repayment to the plan of the amounts that didn’t meet the plan hardship requirements or Section 401(k).

**Example 1:**
Employer L maintains a 401(k) plan with plan assets that exceed $500,000, but is less than ten million. Plan provisions don’t allow for hardship distributions. Employer L made hardship distributions to some employees during the 2014 and 2015-plan years. During a review of its plan operations, Employer L determined that it had made these hardship distributions available to all employees and that it had met the rules for hardship distributions.

**Correction programs available:**

**Self-Correction Program:**
This mistake is considered an operational error. If L determines it has established practices and procedures in place to promote the overall compliance of their plan, it may correct the mistake under SCP. Although, in general, correction of an operational error through plan amendment isn’t permissible under SCP, the provision of hardship withdrawals under the plan in a nondiscriminatory manner is one of four instances in which EPCRS allows a corrective amendment under SCP.

Correction would include adopting a retroactive plan amendment, effective January 1, 2014, to provide for the hardship distributions that Employer L made available. The amendment must provide that the hardship distribution option is nondiscriminatory.

**Voluntary Correction Program:**
Employer L may also correct the mistake under VCP per Revenue Procedure 2018-52 if the plan is not under audit by adopting a retroactive plan amendment, effective January 1, 2014, to provide for the hardship distributions it made available. The amendment must provide that the plan make the hardship distribution option nondiscriminatory. Employer L makes its VCP submission, it should consider using the model documents set forth in the Form 14568 series. The user fee for a 2019 VCP submission, based on plan assets that exceed $500,000 but is less than ten million dollars, $3,000.

**Audit Closing Agreement Program:**
Employer L may also correct this error under Audit CAP (see example 3).

**Example 2:**
Same facts as Example 1, except Employer L didn’t make the distributions available to all employees and only made a hardship distribution to an HCE.
Correction programs available:

Self-Correction Program:
Since Employer L didn't make hardship distributions available to all employees, correction by retroactive amendment under SCP isn't available. An alternative correction that's reasonably designed to comply with section 6 of Revenue Procedure 2018-52 will be permitted.

Voluntary Correction Program:
Employer L may also correct the mistake under VCP per Revenue Procedure 2018-52 if the plan is not under audit. However, since Employer L didn’t make the hardship distributions available to all employees and only made them available to select highly compensated employees, EPCRS doesn't permit a retroactive plan amendment to correct this mistake because it won't satisfy the nondiscrimination rules. An alternative correction that's reasonably designed to comply with section 6 of Revenue Procedure 2018-52 will be permitted. When Employer L makes its VCP submission, it should consider using the model documents set forth in the Form 14568 series. The user fee for a 2019 VCP submission is $3,000, based on plan assets that exceed $500,000 but is less than ten million.

Audit Closing Agreement Program:
Employer L may also correct this error under Audit CAP (see example 3).

Example 3:
Employer M maintains a 401(k) plan with 20 million of plans assets. Plan provisions allow for hardship distributions to participants. During a review of its operations, Employer M determined that 10 hardship distributions made during the 2012 plan year didn't have proper documentation and it didn't base five distributions on any hardship, but were nothing more than in-service distributions. No written procedures were in place to review a participant's application for a hardship distribution.

Correction programs available:

Self-Correction Program:
This mistake may not be eligible to correct under SCP since no adequate practices and procedures for hardship distributions were in place.

Voluntary Correction Program:
Employer M may correct this mistake under VCP. M must request that the five participants who received distributions not meeting the plan hardship requirements repay the amounts plus earnings to the plan. In addition, M must improve its hardship administrative procedures. Expecting participants to repay these amounts may pose a problem because the participants may have already spent the funds. A plan document requiring spousal consent for distributions, plus possible tax issues on the distributions could further complicate the final correction. Correction will depend on the facts and circumstances of each situation and may include, in some form, paybacks, employer corrective contributions and plan amendments. If this represents your situation, file a VCP submission and work with the IRS agent to determine the proper correction. The user fee for a 2019 VCP submission for a plan with 20 million in plan assets is $3,500. VCP user fees may change in subsequent years. When Employer M makes its VCP submission, it and should consider using the model documents in the Form 14568 series.

Audit Closing Agreement Program:
Under Audit CAP, Employer M and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction. The sanction under Audit CAP is based on facts and circumstances, as discussed in Section 14 of Revenue Procedure 2018-52.
How to avoid the mistake:

- Review the plan document language to determine when and under what circumstances you can make distributions.
- When you amend your plan document, make certain the language for hardship distributions is in the most recent document.
- Establish hardship distribution procedures working with your benefits professional to determine if these procedures are sufficient to avoid mistakes.
- Only allow hardship distributions that meet the plan document and IRC Section 401(k) requirements.
- Look for signs that the hardship distribution program is being abused or badly managed.
  - Too many hardship requests by one group or division may be a sign of abuse.
  - Requests for hardship distributions from multiple employees appear identical. Each situation should have its own individual circumstances.
  - Only the highly compensated employees have hardship distributions. This may be a sign that rank-and-file employees haven't been properly notified of the availability of hardship distributions.