<u>Are hardship distributions destroying your 401(k) plan?</u>

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"But it sounds like a hardship to me!" As a consultant and third party administrator for 401(k) plans, I frequently hear this lament from plan sponsors. Yet, since hardship is one of the only circumstances where a distribution can be made to an active employee before age 59½ the meaning of "hardship" takes on considerable importance.

According to IRS regulations published in 1988, a hardship distribution must meet two not-so-bright line tests. In order for a distribution to qualify as a hardship, the distribution both must be <u>on account of an immediate and heavy financial need</u> of the employee and <u>necessary to satisfy the financial need</u>. In typical IRS fashion, these determinations can be based upon a "facts and circumstances" standard. Many plan sponsors, however, choose to forsake the overall facts and circumstances standards and use the simpler IRS "safe-harbor guidelines". This approach is cost efficient and eliminates any discretionary aspect.

Thus, for many plans, an immediate and heavy financial need is defined to be one which is required for (1) medical expenses, (2) purchase of a principal residence, (3) payments necessary to prevent eviction or mortgage foreclosure on that residence, or (4) payment for educational expenses (including room and board) for the participant, spouse or dependents; and the distribution is necessary to satisfy the financial need if (1) the amount distributed is not in excess of the financial need, (2) the employee has exhausted other avenues available under the plan, and (3) the employee stops deferring for twelve months, and when deferrals do commence they are limited to less than the maximum allowable.

So what does a plan administrator do when a valued employee has a true hardship which is not covered under the safe-harbor guidelines? The only choice appears to be to go to the "facts and circumstances" approach. But, there is another approach--eliminate the hardship distribution provisions completely from the plan and replace them with a well designed plan loan program!

Let's look at the practical side of the situation. Employee A, a valued worker, comes to the administrator requesting a hardship distribution to purchase a used car, explaining that his current car is beyond repair and that he requires a car to drive the thirty miles to work. The administrator, using the IRS safe-harbor guidelines, cannot grant the distribution. The employee is left with no alternative but to seek employment closer to home. If the administrator changes to the "facts and circumstances" approach, the distribution may qualify. Of course, in order to use this approach, the plan must be amended to contain specific non-discriminatory and objective standards.

The next week Employee B, another valued worker, requests a hardship distribution to purchase his new car. This employee, who happens to live a short five minute walk from the office, explains that he has given his current vehicle to his daughter so that she can have a car while she attends Princeton and he needs to buy another Porsche. Need I say more? According to the IRS, a plan may not have a general "catch all" category, and plans may not provide for discretionary determinations of hardship by the plan administrator.

But let's suppose that you can get by this problem. You are still faced with the "amount necessary to satisfy the financial need" criteria. What do you do with Employee A when he comes back with the financial need requirements to get his new purchase repaired? Practically speaking, how many "hardship distributions" can be granted? Do your participants view their 401(k) plan as a secondary "credit union" with requests for "hardship distributions" coming monthly?

Remember also that hardship distributions are limited only to elective deferrals. Income on these deferrals and amounts treated as elective deferrals are not available for distribution. To the participant who has invested wisely and who needs a distribution quickly, this restriction can cause human relations problems.

Also, remember that Uncle Sam wants a piece of the distribution. In addition to the 10% penalty for early distribution, there is the 20% mandatory withholding requirement. Fortunately, the hardship distribution can be "grossed up" to allow for taxes without violating the amount criteria--so the participant winds up taking more out of his retirement savings than he truly needs not even considereing the potential lost investment return.

Finally, remember that once the distribution is granted, the employee must cease deferring for twelve months. This means that for ADP testing the participant is included with a zero deferral. Since hardship distributions are generally granted to the non-highly compensated employee, this lowers the average deferral percentage and has a direct impact on the amount available for deferrals to the highly compensated employees. Try explaining this to the Company President when she asks why she can't defer the full $10,000.

Notwithstanding all these "advantages" of hardship withdrawals, plan sponsors should consider a well formulated loan program for the following reasons:

1. **Loan programs can have a general "catch all" category and can permit discretion by the administrator.** In a well designed program, loans should be granted only after approval by the administrator (or a plan loan committee). The approving authority can request information regarding a demonstrated financial need. The following categories permit automatic approval:

a) The safe harbor hardship categories (medical, home preservation, educational expenses, home purchase);

b) Payment of funeral and burial expenses;

c) Payment of federal, state or local income taxes;

d) Other similar expenses which the approving authority may determine to be generally appropriate to meet a participant's demonstrated financial need.

2. **Loan programs have no statutory requirement on the amount or number of loans which are available.** Workable programs which enable the administrator to counsel the participant on the amount needed are helpful. Some programs permit only one loan at a time and do not allow for renegotiation if rates change. Wtry to use the IRS standard of 50% of the vested participant account balance and limit the payback period to five years. It can be advantageous to stay away from the 30-year exception for loans used to purchase a principal residence.

3. **Loans are not distributions if the IRS standards are met.** Therefore, there is no withholding requirement and no 10% penalty for premature distributions. Also, the participant gets to pay back the amount to his own account. In order to minimize the probability of default, require payback for active participants to be through payroll withholding. Terminated participants must, of course, remit a check directly to the Trustees. Default results in the same position as if the participant took a hardship distribution. The participant has deemed income and will be required to pay tax--but there is no advance withholding. A similar situation occurs if the participant needs more than the IRS limits. The excess is treated as a distribution and becomes a taxable event.

4. **Loans do not affect the deferral or match percentage testing.** Since there is no bar to the participant continuing to defer after a loan is made, there is no adverse impact on the testing. Participants are free to continue or not. This is especially helpful for participants who only need the funds for short periods at a time.

When compared to hardship distributions, functionalplan loan programs can provide much greater flexibility for both the participant and the plan. Incidentally, a plan can be amended to eliminate or modify hardship distribution language, since according to the IRS, a provision providing hardship distributions is not a protected accrued benefit. Think about it.