



Understanding Hardship Withdrawals

What a Plan Sponsor needs to know (Page 1 of 2)

Many 401(k) plans allow for plan participants to make early withdrawals from their account for certain allowable hardships. If your company's plan includes provisions for such withdrawals, you should be aware of:

- What constitutes an allowable hardship;
- How a hardship distribution is processed;
- What are the consequences to the participant; and
- What are the responsibilities of the plan sponsor.

According to the Internal Revenue Service, a 401(k) plan may allow for the distribution because of a participant's "immediate and heavy financial need" and defines such needs as:

- Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- Funeral expenses for employee, their spouse, children, or dependents; or
- Certain expenses relating to the repair of damage to the employee's principal residence.

Hardship distributions from a 401(k) plan are limited to the amount of the employee's elective deferrals and generally do not include any income earned on the deferred amounts. If the plan permits, certain employer matching contributions and employer discretionary contributions may also be included in hardship distributions.

A distribution may not be treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee.



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Distribution Processing

The process varies from provider to provider, but typically begins with an inquiry by either the plan sponsor or the participant to their plan administrator. The administrator will assist with the necessary paperwork, but the determination of whether the need is "immediate and heavy" and meets IRS requirements will be that of the plan sponsor.

Participant Consequences

If the hardship withdrawal is approved, the participant should be made aware that, in addition to the reduction in available retirement funds, any withdrawal made from their 401(k) plan will be subject to taxation and, if the participant is under age 59½, the imposition of an IRS 10% early distribution penalty. Also, any participant who has made a hardship withdrawal is prohibited from making employee contributions for at least 6 months after receipt of the hardship distribution. It is recommended that any participant considering making a hardship withdrawal consult a qualified tax accountant to determine any additional financial impacts.

Plan Sponsor Responsibilities

As mentioned prior, the determination of whether a hardship exists or not lies primarily with the plan sponsor. Another important plan sponsor responsibility is making sure that employee deferrals are stopped for at least six months for any participant receiving a hardship distribution. In the event that an ineligible employee is allowed to make elective deferrals into the company's 401(k) plan, it is also the responsibility of the plan sponsor to take corrective measures to stop the deferrals and to bring the plan back into compliance. This is especially important for companies using outside payroll services because they must coordinate both the stopping of ineligible deferrals and the institution of corrective measures with the outside service provider.

Corrective Measures

Fortunately, there are allowable methods available to plan sponsors to correct instances of ineligible deferrals. The simplest method is to forfeit the improperly made 401(k) contributions and make the employee "whole" outside of the plan. The forfeitures can be used to reduce future employer contributions. One method of making the employee whole would be to increase their next paycheck by the ineligible deferral amount. This method works regardless of whether the deferral was a pre-tax elective deferral or a designated Roth contribution.

For other corrective options available to plan sponsors, or for questions regarding hardship and other types of 401(k) plan withdrawals, please feel free to contact your PlanTech retirement plan administrator.



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