



Hardship Distribution Mistakes in a 401(k) Plan

The Problem

A 401(k) plan permits participants to receive hardship distributions. The distributions, however, do not satisfy the plan provisions relating to hardship distributions.

Example: George is the 100 percent owner of the George Company. The company sponsors a 401(k) plan, which provides that a participant may take a distribution on account of hardship. The plan document requires that a participant may only receive a hardship distribution for the following reasons:

- To purchase a principal residence;
- To prevent eviction from, or foreclosure on, the principal residence;
- To pay certain medical expenses incurred by the participant, participant's spouse or dependents; or
- To pay certain educational expenses incurred by the participant, participant's spouse or dependents.

In addition, the plan document requires that the participant use all other sources of financing, including proceeds from insurance, liquidation of other assets and loans from other commercial sources, before applying for a hardship distribution. Jim, a plan participant, asked for and received a hardship distribution of \$20,000 from the plan. He did not provide a reason for the distribution and did not establish that he had used other sources of financing before applying for the hardship distribution.

Finding the Mistake

In order to find the mistake, review:

- The plan document to determine when distributions may occur;
- Each plan distribution and its related documentation showing the reason for the distribution (e.g., distribution form signed by the participant indicating the reason for the distribution); and
- Whether distributions designated as "hardship distributions" were made in accordance with the terms of the plan.

In the example above, Jim did not complete any distribution forms. The only documentation in the file was a note requesting a hardship distribution for \$20,000. It was found that Jim used the money to buy a car. There was no evidence that he investigated other sources of financing.

This was an isolated instance. For each of the other hardship distribution requests, the participant was required to complete a distribution form. The distribution form required the participant to specify the purpose for the distribution (e.g., medical expense, education expense, purchase of residence) and to certify that other sources of financing (including insurance proceeds, disposition of other assets or other

loans) were not available to the participant. The distribution form was then submitted to the employer's accountant, who evaluated the form before approving the hardship distribution to the participant. When Jim applied for a distribution, however, he went directly to George, who authorized payment without requiring Jim to complete the distribution form. Also, George was not familiar with the terms of the plan. As a result, he approved a distribution that did not comply with those terms.

Fixing the Mistake

The company should take reasonable steps to ensure that Jim returns the erroneously distributed amounts to the plan. Jim should also be advised that to the extent any amounts are not returned, they are not eligible for tax favored treatment (i.e., the amounts are not eligible for rollover to an IRA or other retirement plan). In addition, the plan's administrative procedures should be revised to ensure that the error does not occur again. (See Avoiding the Mistake below.)

Correction Program(s) Available

The plan may use the correction programs described in Revenue Procedure 2006-27 to correct the mistake. If the plan is not the subject of an IRS examination, then the plan will generally be able to correct the mistake using either the Self-Correction Program (SCP) or the Voluntary Correction Program (VCP). If the plan is under IRS examination, then mistakes are generally corrected pursuant to a closing agreement under the Audit Closing Agreement Program (Audit CAP). However, if the mistake is an isolated instance (as is the case in this example), the mistake may still be eligible for correction under SCP.

Avoiding the Mistake

George should be familiar with the terms of the plan. A formal approval process had been installed to ensure that hardship distributions comply with the terms of the plan, including documenting the reason for the hardship and certification of the unavailability of other sources of money. George should be aware of the purpose of such a process, and understand the risks of approving distributions without following it. George should not approve distributions based on verbal or informal written requests, but instead, should follow the formal approval process before authorizing a hardship distribution.

Source: IRS Retirement News for Employers