

IRS Clarifies Substantiation of 401(k) Plan Hardship Distributions

Background

Many 401(k) plans allow plan participants to withdraw their elective deferrals prior to termination of employment on account of hardship. A distribution is made on account of hardship only if the distribution is both (a) made on account of an immediate and heavy financial need of the participant (the “need”) and (b) necessary to satisfy the need (the “amount necessary”). A plan may utilize hardship distribution safe harbors in the Treasury Regulations. If a participant’s circumstances fall within the safe harbors, a distribution to the participant will be “deemed” to satisfy the need and amount necessary hardship requirements. Safe harbor needs include, for example, medical expenses, tuition, pending foreclosure and funeral expenses.

Employers have sometimes struggled with just how to substantiate compliance with these hardship requirements. This is important because if an employer cannot properly substantiate all hardship distributions, the employer could be subject to tax penalties.

The Internal Revenue Service (IRS) has issued an internal memorandum, dated February 23, 2017, to its agents who audit employee plans describing how a plan can substantiate its compliance with the safe harbor need requirement. While employers cannot rely on the IRS memorandum as legal guidance, the memorandum nevertheless provides useful insight into the IRS’s thinking on this matter.

Substantiating a Safe Harbor Need

According to the IRS memorandum, an employer can substantiate a safe harbor need by obtaining from the participant either (a) copies of backup documentation (e.g., estimates, contracts, bills or statements from third parties) or (b) a summary (in paper or electronic format or telephone records) of the information in the backup documentation. If the employer uses approach (b), the memorandum requires that the employer provide the participant with certain notifications about the hardship distribution requirements (including that the participant will preserve, and make available upon request, the backup documentation) and obtain from the participant specific information about the hardship, depending on the type of safe harbor hardship (listed above). A copy of memorandum’s list of notification and summary of backup documentation requirements is attached to this article.

As a best practice, employers who self-administer their plans’ safe harbor hardship distribution features should:

- retain and refer to this list to ensure that they obtain proper substantiation for all hardship distributions, and
- document proper substantiation in the employer's records, with a record of all hardship distributions including copies of backup documentation or notifications provided to, and information received from, participants who request hardship distributions.

The IRS memorandum appears to validate an entirely electronic "self-certification" hardship distribution process, which is offered by many 401(k) plan platform providers, if it satisfies the notification and summary of backup documentation requirements in the memorandum. Additionally, if an employer outsources administration of hardship distributions using an employee self-certification approach, the memorandum requires the administrator to provide the employer with an annual report or other data describing the hardship distributions made during the plan year.

More Than Two Hardship Distributions Per Year: A Red Flag?

Interestingly, the IRS memorandum highlights for potentially higher scrutiny by IRS agents the situation where an employee receives more than 2 hardship distributions in a single plan year. While this would not be a per se violation of the applicable 401(k) plan rules, perhaps IRS views this as a red flag that an employer may be making purported hardship distributions for reasons other than the safe harbor "needs" listed above. The memorandum gives some possible reasons why a participant might justifiably receive more than 2 hardship distributions in a plan year: follow-up medical or funeral expenses or tuition on a quarterly school year. An employer that otherwise uses employee self-certification might police this issue by requiring an employee who requests a third hardship distribution in a plan year to produce backup documentation for all of his or her hardship distributions during that year.

Conclusion

If an employee wants to take a hardship distribution, the employer may require that the employee provide it with actual documents substantiating the financial need, such as bills, estimates and third-party statements. Alternatively, the employer can provide the employee with a written notice, solicit certain information from the employee and tell the employee that he or she must retain the backup. If you want a copy of a written notice or want help setting up your 401(k)-compliant hardship procedures, please contact us, and we will be happy to help.

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HARDSHIP SUBSTANTIATION INFORMATION AND NOTIFICATIONS FOR SUMMARY OF SOURCE DOCUMENTS

I. Notifications that the Employer/Administrator Must Provide to the Employee

- The hardship distribution is taxable and additional taxes could apply
- The amount of the distribution cannot exceed the immediate and heavy financial need
- Hardship distributions cannot be made from earnings on elective contributions or from QNEC or QMAC accounts, if applicable
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator

II. General Information for All Hardship Requests

- Participant's name
- Total cost of the event causing hardship (for example, total cost of medical care, total cost of funeral/burial expenses, payment needed to avoid foreclosure or eviction)
- Amount of distribution requested
- Certification by the participant that the information provided is true and accurate

III. Specific Information on Deemed Hardships

A. Medical Care

- Who incurred the medical expenses (name)?
- What is the relationship to the participant (self, spouse, dependent, or primary beneficiary under the plan)?
- What was the purpose of the medical care (not the actual condition but the general category of expense, for example, diagnosis, treatment, prevention, associated transportation, long-term care)?
- Name and address of the service provider (hospital, doctor/dentist/chiropractor/other, pharmacy)
- Amount of medical expenses not covered by insurance

B. Purchase of Principal Residence

- Will this be the participant's principal residence?
- Address of the residence
- Purchase price of the principal residence
- Types of costs and expenses covered (down-payment, closing costs and/or title fees)
- Name and address of the lender
- Date of the purchase/sale agreement

- Expected date of closing

C. Educational Payments

- Who are the educational payments for (name)?
- What is the relationship to the participant (self, spouse, child, dependent, or primary beneficiary under the plan)?
- Name and address of the educational institution
- Categories of educational payments involved (post-high school tuition, related fees, room and board)
- Period covered by the educational payments (beginning/end dates of up to 12 months)

D. Foreclosure/Eviction from Your Principal Residence

- Is this the participant's principal residence?
- Address of the residence
- Type of event (foreclosure or eviction)
- Name and address of the party that issued the foreclosure or eviction notice
- Date of the notice of foreclosure or eviction
- Due date of the payment to avoid foreclosure or eviction

E. Funeral and Burial Expenses

- Name of the deceased
- Relationship to the participant (parent, spouse, child, dependent, or primary beneficiary under the plan)
- Date of death
- Name and address of the service provider (cemetery, funeral home, etc.)

F. Repairs for Damage to Principal Residence

- Is this the participant's principal residence?
- Address of the residence that sustained damage
- Briefly describe the cause of the casualty loss (fire, flooding, type of weather-related damage, etc.), including the date of the casualty loss
- Briefly describe the repairs, including the date(s) of repair (in process or completed)