

NEW HARDSHIP WITHDRAWAL SUBSTANTIATION GUIDANCE

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Employee Benefits

The Internal Revenue Service (IRS) recently published two memos for its employees who audit employee plans that provides substantiation guidelines when they are examining whether a 401(k) or 403(b) plan hardship distribution is “deemed to be on account of an immediate and heavy financial need” (medical care expenses, purchase of principal residence, post-secondary education expenses, funeral expenses, etc.) under the safe-harbor hardship withdrawal standards – one memo pertains to 401(k) plans and the other one pertains to 403(b) plans. A 401(k) or 403(b) plan may, but is not required to, allow participants to receive a distribution of elective contributions from the plan on account of hardship. Those 401(k) and 403(b) plans that do allow for hardship withdrawals are not required to make use of the safe harbor hardship withdrawal ruled described in the 401(k) regulations, but many if not most do. And the 403(b) rules make it clear that a 403(b) plan may rely on the safe harbor hardship withdrawal that appear in the 401(k) regulations.

Where a 401(k) or 403(b) plan does allow for hardship distributions and does make use the safe harbor standards, the recent IRS memos prescribe a multi-step inquiry that the IRS examiner is expected to undertake to determine whether a hardship distribution is being made on account of a deemed immediate and heavy financial need. Those guidelines suggest that plans granting hardship distribution withdrawals under the safe harbor hardship withdrawal standards will have two different options for substantiating an immediate and heavy financial need.

Option 1 - Source Documents. A plan, prior to making the hardship distribution may obtain from the participant certain “source documents” (such as estimates, contracts, bills and statements from third parties) relating to the hardship distribution. If the plan relies on those source documents to substantiate the hardship request, an IRS examiner would expect to be able to review those documents to determine if they substantiate the hardship distribution – so proper retention of those source documents in the event of a future plan audit would be needed.

Option 2 - Summary of Information. Alternatively, the plan, instead of obtaining the source documents discussed above, may rely on a summary (in paper, electronic format, or telephone records) of the information contained in source documents. If a plan intends to make use of the “summary of information” approach to substantiate a hardship distribution, the IRS examiner will look for the following procedural steps

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to have been followed:

- The plan sponsor or the third party administrator will be expected to have provided certain notifications to the plan participant before making the hardship distribution, including the fact that the hardship distribution is taxable and potentially subject to additional taxes, the amount distributed cannot exceed the amount of the immediate and heavy financial need, and *the recipient agrees to preserve the source documents and to make those documents available at a later time if the plan sponsor or the third party administrator so requests*. More detail on the contents of the notifications can be found in an attachment to the IRS memo.
- The summary of information must contain certain information that also is spelled out in an attachment to the memo sent to IRS examiners.
 - There is general information applicable to all categories of hardship requests (participant name, a description of the hardship event, the total cost of the event causing the hardship, the amount of the distribution requested, and a certification from the participant that the information provided is true and accurate) that must be included in the summary of information maintained for each hardship distribution.
 - The summary of information also must contain certain other information specific to the type of hardship for which the distribution is being requested. If, for example, a hardship is requested for the purchase of a principal residence, the summary must identify whether the home that is purchased will be the participant's principal residence, the address of the residence, the purchase price of the residence, the types of costs and expenses covered (down-payment, closing costs, title/fees, etc.), the name/address of lender, the date of purchase sale agreement, and the expected date of closing. A complete listing of the hardship-specific information that is required to be maintained for each type of hardship when using the summary of information approach is outlined in the attachment to the IRS memos.
- If a plan is using a third-party administrator to obtain a summary of information contained in source documents, the plan sponsor should receive from the third-party administrator a report or other access to data to the employer, at least annually, describing the hardship distributions made during the plan year.

The good news is that the recent IRS memos offers some flexibility as to what works in terms of substantiating a hardship distribution. The bad news is that the so-called "self-certification" approach to processing hardship distributions may no longer work from a substantiation perspective. The guidance contained in these recent IRS memos, while they are not binding legal pronouncements, should nevertheless prompt sponsors (together with their third-party administrators) that have plans with a hardship distribution feature to evaluate and potentially modify their hardship distribution procedures. Sponsors (together with their third-party administrators) will want to strongly consider having plan procedures and participant communications (summary plan descriptions, administrative forms, websites, etc.), going forward, that are designed so that information sufficient to satisfy a request for substantiation is obtained by the plan in the event of an IRS examination. And while the summary of information approach, on its face, may be seen as a procedurally friendlier approach, it is important to recognize that the summary of information approach ultimately requires the participants to have *and retain* the underlying source documents – those source document still could be requested in the event of an IRS examination.

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The complete IRS memorandum relating to 401(k) plans can be found here: <https://www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf>. The complete IRS memorandum relating to 403(b) plans can be found here: <https://www.irs.gov/pub/foia/ig/spder/tege-04-0317-0010.pdf>.

