

IRS Issues Guidance on Substantiating Hardship Withdrawals from 401(K) Plans

Legal Alert

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The IRS recently issued guidelines for plan examiners to review hardship withdrawal distributions from 401(k) plans. Although the guidelines are intended for internal IRS use, they offer helpful insights for plan sponsors (employers) or administrators to develop procedures for substantiating that the withdrawal is necessary to meet the “immediate and heavy financial need” caused by the financial hardship.

THE BACKGROUND:

Generally, employee deferrals to a 401(k) plan cannot be distributed to the participant before separation from service or attainment of age 59½, except on account of financial hardship. Employers often allow hardship distributions in order to encourage employees to make elective deferrals to the plan, so that they don't feel that their money is tied up indefinitely in the event of a financial emergency. A hardship distribution must meet two requirements:

- It must be on account of an immediate and heavy financial need; and
- The distribution cannot exceed the amount necessary to satisfy the financial need.

IRS regulations include a “safe harbor” for six kinds of expenses that will automatically satisfy the financial need requirement: (1) home purchase; (2) medical; (3) tuition; (4) prevent eviction; (5) funeral; and (6) home repairs. As a practical matter, many employers or administrators limit the availability of hardship distributions only to these six types of expenses to minimize the risk of making an in-service distribution that would violate the rules.

Despite the safe harbor, there has been uncertainty about the supporting documentation employers and administrators need to substantiate the existence of – and the amount needed to satisfy – a financial hardship. In the absence of specific guidance on the issue, many employers and administrators require participants to submit the source documents for verification (*e.g.*, tuition invoices, agreement of sale for a house purchase). The employer (or administrator) has an implicit obligation to review the source documents to verify the nature and amount of the hardship claimed by the participant and should retain those documents for its records in the event of an audit.

WHAT THE GUIDELINES DO:

For hardship distributions that meet one of the safe harbors, the new guidelines now permit the employer or administrator to rely on the participant's self-certification of the immediate and heavy financial need and a summary of the applicable expenses instead of getting the source documents. The self-certification and expense summary may be in paper or electronic format. Employers or administrators that decide to accept a

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summary must provide a notice to each requesting participant that includes the following information:

1. The hardship distribution is taxable and additional taxes could apply;
2. The amount of the distribution cannot exceed the immediate and heavy financial need (but may include an extra amount sufficient to pay the taxes on the distribution);
3. Hardship distributions cannot be made from (a) earnings on elective contributions or (b) amounts contributed by the employee to satisfy the non-discrimination testing for elective deferrals or matching contributions, if applicable; and
4. The employee must agree to preserve the source documents and to make them available to the employer or administrator at any time upon request.

The hardship withdrawal request must also include the total cost of the event causing the hardship, the amount requested, and the participant's certification that the information provided is true and correct. The guidelines also include a list of specific information that should be requested for each type of safe harbor hardship.

OBSERVATION:

Plan sponsors and administrators who use the expense summary method run a risk that a requesting participant will not be able to produce the related source documents upon demand (such as for an IRS examination). Since the guidelines put the onus on the participant to produce these documents if necessary, the plan sponsor should have a legitimate excuse if it cannot provide the substantiation as long as it can demonstrate compliance with the guidelines. Unfortunately, it is not yet known how IRS agents will deal with such a situation in the field.

Of course, the employer or administrator could adopt a "belt and suspenders" approach and collect source documents together with the participant's self-certification. However, this approach is not without risk. The employer could be responsible for making an impermissible hardship distribution if the source documents contradict the self-certification, but it failed to review the source documents (even though they were available) and chose to rely on the participant's certification instead.

BOTTOM LINE:

Although the new IRS guidelines do not have the same authority as a regulation or revenue ruling, they still provide welcome advice that can lessen the administrative burden of allowing hardship withdrawals. By permitting a plan sponsor or administrator to rely on a participant's self-certification, these guidelines allow hardship distribution processing to be standardized and substantially simplified. While there are still open questions regarding potential problems (as noted above), on balance the new guidelines should make it easier for employers to permit hardship distributions from their 401(k) plans.

Our Employee Benefits attorneys can assist plan sponsors and administrators in establishing procedures and developing notifications and forms to comply with the IRS guidance and many other matters relating to the administration and operation of tax-qualified retirement plans. For further information, please contact Allen Fineberg or Marc Garber.

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ATTORNEYS MENTIONED

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