

(Mild) Relief for Safe-Harbor Hardship Administration

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Provided that certain notice requirements have been satisfied, employers and third-party administrators (“TPAs”) can now allow participants requesting safe-harbor hardship distributions to provide a summary of information contained in source documents evidencing their hardship event in lieu of the source documents, as long as they maintain the source documents themselves.

On February 23, 2017, the Internal Revenue Service (“IRS”) issued a memorandum setting forth substantiation guidelines for Employee Plans (“EP”) Examination employees examining whether a 401(k) plan hardship distribution “is deemed to be on account of an immediate and heavy financial need” under safe-harbor standards set out in the Income Tax Regulations (“Regulations”). Under the Regulations a hardship distribution from a 403(b) plan has the same meaning as a hardship distribution from a 401(k) plan, and therefore, the memorandum also applies to hardship distributions from 403(b) plans.ⁱ

The memorandum provides guidance for EP Examination employees and is not a pronouncement of law which can be relied on. However, it does provide insight as to how the safe-harbor standards for 401(k) and 403(b) plan hardship distributions will be examined. The memorandum is in force for two years, until February 23, 2019.

Background

Section 401(k) plans generally may, but are not required to, allow employees to receive a distribution of elective contributions from the plan on account of hardship. A distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee *and* is necessary to satisfy such financial need.ⁱⁱ

A distribution is deemed to be on account of an immediate and heavy financial need if it is for one or more of the items below and the need cannot be relieved from other resources reasonably

available to the employee, including assets of the employee's spouse and minor children, based on facts and circumstances:ⁱⁱⁱ

1. Expenses for (or necessary to obtain) medical care that would be deductible under Section 213(d) of the Internal Revenue Code (the "Code") for the employee or the employee's spouse, children or dependents (as defined in Code Section 152) or primary beneficiary under the plan;
2. Costs directly related to the purchase of a principal residence for the employee;
3. Payment of tuition, related educational fees, room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children or dependents (as defined in Code Section 152) or primary beneficiary under the plan;
4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
5. Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in Code Section 152) or primary beneficiary under the plan; or
6. Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Code Section 165.^{iv}

Plans that provide for safe-harbor hardship distributions must still provide the specific criteria used to make the determination of hardship. For example, a plan may provide that a distribution can be made only for medical expenses, but not for payment of tuition and education expenses.

Prior to 2015, some plans required detailed documentation for hardship requests while others simply asked participants to self-certify that a hardship existed. In an April 1, 2015 publication, the IRS said that plans must obtain and keep hardship distribution records, and that the failure to have these records available for examination is a qualification failure that should be corrected using the Employee Plans Compliance Resolution System.^v This publication emphasized that self-certification was not acceptable to document a hardship.

The memorandum seems to accommodate alternative substantiation methods, including methods that are more compatible with electronic administration.

Administrative Guidelines

The IRS instructs that EP Examination employees follow the two-step process discussed below when determining whether a plan's hardship distributions are for safe harbor events, based on either source documents or summaries of source documents. Attachment I to the memorandum describes notifications that must be given and information that must be obtained when a plan relies on source document summaries.

Step 1

The EP Examination employees must first determine whether the employer or TPA, prior to making a distribution, obtains: (a) source documents (such as estimates, contracts, bills and statements from third parties); or (b) a summary (in paper, electronic format, or telephone records) of the information contained in source documents.

For example, source documents for a home purchase would include things like a copy of the purchase agreement signed by the buyer and the seller that includes the closing date and the balance of the purchase price.

If the employer or TPA obtains a summary of the information, the EP Examination employees must determine whether the employer or TPA provides the employee with notification that states:

- 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.^{vi}

Step 2

If the employer or TPA obtains source documents, the EP Examination employees will review the documents to determine if they substantiate the hardship distribution. If instead they obtain a summary of information on source documents, they will review the summary to determine whether it contains the following information:

1. 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

2. Specific Information on Deemed Hardships

A. Medical Care

- Who incurred the medical expenses (name)?

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- 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)

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- 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)

The EP Examination employees may ask for source documents if they determine that the required notifications provided to employees or the summary of information on source documents is incomplete or inconsistent on its face.

The memorandum also advises EP Examination employees to scrutinize instances when employees have received more than two hardship distributions in a plan year. Even if an examiner determines that the employer or TPA has obtained a complete and consistent summary of information on source documents, in the absence of an adequate explanation for the multiple distributions (*i.e.*, follow-up medical or funeral expenses or tuition on a quarterly school calendar), the examiner may ask the employer or TPA for source documents to substantiate the distributions.

Finally, if a TPA obtains a summary of information contained in source documents, the TPA should provide the employer with a report or other access to data, at least annually, describing the hardship distributions made during the plan year.

Takeaways

The memorandum provides for some flexibility to employers and TPAs by allowing them to rely on summaries of information from participants. Employers and TPAs that currently require source

documents to substantiate hardship distributions do not need to make any changes to their procedures. While they may want to consider whether collecting summaries might streamline their practices, their current practices assure that documentation is available upon an audit without having to rely on participants' recordkeeping abilities to satisfy any substantiation requests by the IRS. As a caution, employers and TPAs should continue to require source documents for non-safe-harbor distributions.

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- ⁱ See 26 C.F.R. § 1.403(b)-6(d)(2); see also IRS Memorandum for Employee Plans Examination Employees, "Substantiation Guidelines for Safe-Harbor Hardship Distributions from Section 403(b) Plans" (March 7, 2017).
 - ⁱⁱ See 26 C.F.R. § 1.401(k)-1(d)(3)(i).
 - ⁱⁱⁱ See 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(B).
 - ^{iv} See 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B).
 - ^v Employee Plans News, available at https://www.irs.gov/pub/irs-tege/epn_2015_4.pdf
 - ^{vi} Although an agreement by the participant to preserve source documents may relieve certain burdens of hardship administration, we question what adverse consequences would result for a plan, if any, when a participant fails to maintain those source documents.
 - ^{vi} These items are taken directly from Attachment I to the memorandum.

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