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## BENEFITS & COMPENSATION UPDATE

By: *Judy M. Hensley and Charles C. Shulman*

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### *IRS Issues Guidelines for Substantiating 401(k) Hardship Withdrawals*

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In February, the IRS issued a memorandum providing guidance to examination agents regarding their review of substantiation of safe harbor hardship distributions under 401(k) plans.<sup>1</sup> While not official guidance, the memorandum provides a helpful reference for what documentation and internal controls plan administrators should have in place in order to avoid issues on audit.

#### **Background**

In-service distributions from 401(k) plans are permitted on account of “an immediate and heavy financial need” of an employee that reasonably cannot be satisfied from other sources, including plan loans. Treasury regulations provide certain safe harbor hardship distributions that – *if properly substantiated* – are deemed to be on account of an immediate and heavy financial need, including distributions needed to:

- obtain medical care for the employee, the employee’s spouse, children or dependents;
- purchase a principal residence or prevent eviction from or foreclosure on the employee’s principal residence;

- pay tuition and other qualified education expenses for the employee, the employee’s spouse, children or dependents; and
- cover funeral or burial expenses for the employee’s parents, the employee’s spouse, children or dependents.

#### **Memorandum Guidance**

The memorandum indicates that, when reviewing a 401(k) plan’s hardship distributions under audit, the agent should examine (i) so-called source documents (e.g., estimates, contracts, bills and statements by third parties) or (ii) a summary of the information contained in the source documents. Unlike prior informal guidance issued in 2015 that indicated that a plan administrator could not substantiate the existence of a heavy and immediate hardship through the employee’s self-certification, this recent memorandum’s reference to “summary of information” seems to indicate tacit approval of a streamlined process for substantiating hardships whereby the employee may self-certify the contents of the source documents if he or she also promises to preserve them.

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<sup>1</sup> Earlier this month, the IRS issued a second memorandum clarifying that the guidance also applies to 403(b) plans.

### ***Summary of Information***

The memorandum includes an Attachment that lists the requirements that the plan administrator must satisfy before making the hardship distribution in the situation where a summary of the information is provided by the employee. First, the plan administrator must provide the employee notice that the distribution is taxable, cannot exceed the amount of the immediate and heavy financial need and cannot be made from earnings on elective contributions or from qualified nonelective contributions (QNEC) or matching contributions. Second, and perhaps of greatest significance, the employee must agree to preserve the source documents and make them available at the request of the plan administrator. Third, the summary of information should include the basic information generally applicable to any hardship requests (e.g., employee's name, cost of the event causing the hardship and amount being requested). Finally, the summary should also include the specific information necessary to substantiate the individual hardship event in question (e.g., in the case of a hardship

distribution on account of funeral expenses, name of the deceased, the deceased's relationship to the employee, date of death and name of funeral home or other service provider(s)).

The memorandum indicates that an auditor may ask for the source documents in cases where the summary of information is incomplete or inconsistent on its face or when an employee received more than two hardship distributions in a plan year without adequate explanation for the multiple distributions.

### ***Next Steps***

Plan administrators should review their plan's hardship distribution procedures to ensure compliance with the guidance provided in the memorandum. Although the guidance cannot be relied upon as binding authority, it highlights what procedures should help plan administrators complete a successful hardship distribution audit.

***This update is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.***

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*If you have any questions about this update, please contact:*

Norman J. Misher	212-903-8733	<a href="mailto:nmisher@rhtax.com">nmisher@rhtax.com</a>
Allen J. Erreich	212-903-8769	<a href="mailto:aerreich@rhtax.com">aerreich@rhtax.com</a>
Judy M. Hensley	212-903-8737	<a href="mailto:jhensley@rhtax.com">jhensley@rhtax.com</a>
Charles C. Shulman	212-903-8687	<a href="mailto:cshulman@rhtax.com">cshulman@rhtax.com</a>

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