

IRS Increases Flexibility for Substantiation of Hardship Distributions

After an extended period of uncertainty about what constitutes acceptable substantiation of a hardship withdrawal request, new guidelines for IRS examiners provide clarity. While traditional means of gathering source documents continue to be acceptable, the new guidelines set forth requirements that allow plans to use a summary of those documents instead. The guidelines describe specific information that the summaries must contain, and require that participants agree to preserve source documents and make them available on request. This change will reassure plans that already allow for streamlined substantiation, and could reduce the administrative burden for plans that currently require source documents. The guidelines are effective February 23, 2017 and apply to IRS examinations open on that and future dates.

Background

As an exception to Code rules that generally discourage participants from tapping into retirement funds for other reasons, a plan can allow in-service withdrawals of elective deferrals for narrowly framed “hardship” situations. To satisfy Code requirements for hardship distributions, the participant must have a hardship event – which regulations describe as being “on account of an immediate and heavy financial need” – and the distribution must be necessary to meet that financial need. Employers may use the [safe harbors](#) defined in IRS regulations for hardship distributions deemed to meet these criteria. One safe harbor lists the scenarios that meet the “immediate and heavy financial need” criteria and another addresses the requirement that the distribution is necessary to satisfy that need.

Prior to 2015, while many plans required detailed documentation to substantiate a hardship request, others simply asked the participant to certify that a hardship existed – and informal IRS responses had not objected to this approach. In its [April 1, 2015 Employee Plans News](#) publication, the IRS said plans must obtain and keep hardship distribution records, and that not having these records available upon audit is a plan qualification failure that must be corrected. It emphasized that self-certification is not acceptable to document a hardship. In reaction to the newsletter, stakeholders representing employers and service providers requested further clarification.



In response, the IRS used the [Industry Issue Resolution Program](#) to review and address stakeholder concerns.

Comment: This was the first time that the IRS used the Industry Issue Resolution Program for a matter concerning retirement plans. In this case, the program provided a timely resolution to an issue that was of great concern to administrators.

IRS OKs Summaries of Hardship Distribution Source Documents

In a [February 23, 2017](#) memorandum, the IRS set forth administrative guidelines for agents examining whether hardship distributions meet the “deemed to be on account of an immediate and heavy financial need” requirement under the safe harbor. The guidelines provide that, as an alternative to collecting source documents (such as estimates, contracts, bills, and statements), a plan can use a summary (paper, electronic, or telephone record) of the information contained in the source documents. Additionally, the participant must agree to “preserve source documents and to make them available at any time upon the employer’s or plan administrator’s request” for the summary to substantiate the hardship.

For all types of hardship distributions, the summary must contain the following information:

- Participant’s name
- Total cost of the event causing the hardship (for example, total cost of medical care or total payment needed to avoid foreclosure)
- Amount of distribution requested
- Participant certification that the information provided is true and accurate

As part of the hardship application process, the plan must provide the participant with notice of the taxability of the hardship distribution, that its amount cannot exceed the participant’s immediate and heavy financial need, and that it cannot be made from earnings on elective contributions or from qualified non-elective contribution or qualified matching contribution accounts.

Additionally, the summary must include information specific to the type of hardship involved. The appendix to the memorandum lists the types of substantiation required for each category.

Example: In the case of a hardship distribution on account of educational payments, the summary must specify who the payments are for, the relationship between that individual and the participant, the name and address of the educational institution, categories of educational payments involved (for example, university tuition), and the period covered by the educational payments.

If either the general or category-specific information is incomplete or inconsistent, the agent can ask the plan for source documents. The agent can also ask for source documents if the same participant received more than two hardship distributions in a plan year, absent an adequate explanation for the distributions – for example, follow-up medical bills, funeral expenses following an illness, or tuition paid on a quarterly basis.

A third-party administrator (TPA) administering hardship review and approval must provide the employer at least once annually with a report or other access to data that describes the hardship distributions made during the plan year.

The guidance is effective February 23, 2017 and applies not only prospectively, but to IRS examinations that are open as of that date.

Administrative Considerations

The option of using a summary of data related to the hardship – instead of the source documents themselves – to substantiate a distribution request under the safe harbor gives plans and TPAs welcome flexibility. While not as simple as the self-certification practice some plans and TPAs currently use, complying with the requirements the IRS sets forth for summaries could be far less burdensome than collecting and maintaining the hardship distribution source documents themselves.

Comment: While using a summary may expedite the hardship review process, it is unclear whether administrators can allow online submission of a summary followed immediately by processing of payment – without review of the summary information. Doing so might too closely resemble the self-certification method that the IRS rejected in 2015.

Plans that obtain summaries should ensure that they and/or their TPAs establish procedures to obtain – and document – participants' agreement to preserve the source documents substantiating the hardship and have them available for review, upon request. Depending on the circumstances, the IRS may ask for this material during an audit.

In Closing

While plans that currently require source documents to substantiate hardship distributions need not make any changes to their procedures, the new IRS guidance allows them to consider whether collecting a summary of those documents pursuant to this guidance would streamline their processes. Doing so might allow them to expedite access to money for participants at a time when it is most needed. Conversely, retaining current procedures assures that documentation is available upon audit without having to rely on plan participants' recordkeeping abilities and willingness to satisfy any IRS substantiation request.

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