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The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led ***by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone.*** **WRMarketplace #17-19** was written by Greenberg Traurig Shareholder Ian A. Herbert**.**

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TOPIC: 401(k) Hardship Distributions: IRS Eases Substantiation Requirements.

MARKET TREND: As the current Presidential Administration aims to reduce and simplify reporting and regulatory requirements, new IRS audit guidelines may relax the burden on plan sponsors and administrators to substantiate requests for hardship distributions**.**

SYNOPSIS: Most 401(k) plans allow participants to take distributions while employed in the event of a financial hardship, although IRS regulations strictly define what constitutes a financial hardship. Further, the IRS typically has set stringent audit standards for plans in documenting the satisfaction of distribution requirements, which has frustrated the goal of many plan sponsors and administrators to accomplish more plan administration tasks and requests online. In recent audit guidance to its examiners, however, the IRS has indicated that it will accept participants' summaries of information to support distribution requests, rather than requiring the provision of source documents to verify the expenses giving rise to the hardship.

TAKE AWAYS: Employers should determine whether they wish to take advantage of the greater flexibility afforded in the recently-released IRS audit guidance. If so, they should prepare documents that (1) set forth the required participant notification and (2) solicit the necessary summary information to support a hardship distribution request.

MAJOR REFERENCE: Memorandum for Employee Plans Examinations Employees on Substantiation Guidelines for Safe-Harbor Hardship Distributions from Section 401(k) Plans (EMISC 20170223).

To promote the purpose of saving for retirement, participants in 401(k) plans are prohibited from taking distributions of their elective deferrals before the earlier of their severance from employment or their attainment of age 59.5. The Internal Revenue Code ("**Code**"), however, provides an exception that allows participants to take distributions on account of financial hardship, so that participants will not be discouraged from making plan contributions for fear of later emergencies. Recently-released IRS audit guidelines may now ease the substantiation burden for these hardship distributions for plan administration purposes.

WHAT ARE "HARDSHIP DISTRIBUTIONS"?

General Requirement. To qualify as a "hardship distribution," the distribution must be: (1) "made on account of an immediate and heavy financial need" **and** (2) "necessary to satisfy the financial need." With regard to the second prong of the test, the applicable regulations expressly permit the plan sponsor to rely on the participant's representation that the need cannot be reasonably relieved: (1) through reimbursement or compensation by insurance or otherwise; (2) by liquidation of the participant's assets; (3) by cessation of elective deferrals or other participant contributions under the plan; (4) by other currently available distributions and nontaxable loans under plans maintained by the employer or any other employer; or (5) by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

Safe Harbor. The 401(k) regulations establish a "safe harbor" pursuant to which a distribution will be deemed to be "on account of an immediate and heavy financial need." Specifically, the distribution will meet this safe harbor if it is made on account of one of six enumerated circumstances:

(1) Medical care expenses for the employee or his or her spouse, dependents, or beneficiary;

(2) Costs directly related to the purchase of an employee's principal residence (excluding mortgage payments);

(3) Tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee or his or her spouse, children, dependents, or beneficiary;

(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) Funeral expenses for the employee or his or her spouse, children, dependents, or beneficiary; or

(6) Certain expenses necessary to repair damage to the employee's principal residence.

Distributions may be permitted on account of other circumstances, but they do not fall within the safe harbor and, if not considered a financial hardship by the IRS, can subject the plan to disqualification. Accordingly, ***most 401(k) plans are drafted to limit hardship distributions to the safe harbor reasons.***

WHAT ARE THE SUBSTANTIATION REQUIREMENTS?

Pre-IRS Audit Guidance. While the 401(k) regulations allow plan sponsors to rely on a participant's representation that the distribution was "necessary to satisfy the financial need," before recent guidance, they could not rely on such representations to satisfy the first prong of the hardship distribution test – i.e., that the distribution was being made on account of an "immediate and heavy financial need." Rather, the plan sponsor had to obtain documentary evidence of the expenses that were incurred. For example, before making a hardship distribution, the plan needed to obtain financial information and documentation, such as loan documents, medical bills, tuition statements, etc., that supported the reason for the distribution. These substantiation guidelines were extremely onerous, and conflicted with the desire of plan sponsors and third-party administrators to move to an administrative process that was largely handled electronically.

Post-IRS Audit Guidance. Perhaps in recognition of this issue, the IRS recently released a memorandum to its plan examination agents setting forth less burdensome substantiation requirements that could be accepted in an audit of a 401(k) plan that uses the safe harbor standards (the old rules continue to apply to non-safe harbor distributions). Under the new guidelines, a plan administrator could either obtain "source documents," such as the type of information required under prior substantiation standards, or a summary of the information contained in source documents. There are two components of the new substantiation guidelines for plan administrators that accept summary information to support a hardship distribution: (1) participant notification and (2) content of summary information collected.

Participant Notification. For an employer who is going to accept summary information in substantiation of a hardship distribution request, the participant must be provided with notification that informs him or her of the following facts:

- The hardship distribution is taxable and additional taxes (such as the 10% tax on early distributions) could apply;
- The amount of the distribution cannot exceed the immediate and heavy financial need;
- Hardship distributions can only be made from elective deferrals and not from earnings on elective deferrals or qualified nonelective contributions or qualified matching contributions made under the plan (if any); and

- The recipient agrees to preserve source documents related to the hardship and to make them available at any time, upon request, to the employer or plan administrator.

Content of Summary Information. With respect to any hardship distribution, the plan administrator must collect the following information:

- The participant's name;
- The total cost of the event causing hardship (*e.g.*, total cost of medical care, total cost of funeral/burial/cremation, etc.);
- The amount of the distribution requested; and
- Certification by the participant that the information provided is true and accurate.

With respect to the specific circumstances giving rise to the hardship, different summary information is required. The following table sets forth the required information for each case.

Cause of Hardship	Summary Information Required for Hardship Distribution
Medical Care	• Who incurred the medical expenses? • What is the relationship of that person to the participant? • What was the purpose of the medical care (not the condition, but the general category of expense – diagnosis, treatment, prevention, etc.)? • Name and address of the service provider. • Amount of the medical expenses not covered by insurance.
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 (e.g., down-payment, closing costs, title fees). • Name and address of the lender. • Date of the purchase/sale agreement. • Expected date of closing.
Educational Payments	• Name of the person for whom the payments are being made. • What is the person's relationship to the participant? • Name and address of the educational institution. • Categories of educational payments involved (*i.e.*, post-high school tuition, related fees, room and board). • Period covered by the educational payments (beginning/end dates up to 12 months).
Foreclosure/Eviction	• Is this the participant's principal residence?

Cause of Hardship	Summary Information Required for Hardship Distribution
from Principal Residence	• Address of the residence. • Type of event (*i.e.*, foreclosure or eviction). • 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.
Funeral and Burial Expenses	• Name of the deceased. • Relationship to the participant. • Date of death. • Name and address of service provider.
Repairs to Damage of Principal Residence	• Is this the participant's principal residence? • Address of the residence that sustained damage. • Brief description of the cause of the casualty loss (*e.g.* fire, flooding, weather-related damage, etc.), including the date of the casualty loss. • Brief description of the repairs, including date(s) (in-process or completed).

WHAT IS THE POTENTIAL IMPACT?

The recently issued IRS memorandum, while not something that plan sponsors are allowed to rely on, indicates that the IRS will be more flexible on audit in finding that plan administrators have properly determined whether hardship distributions are permitted in any given instance. This change, in turn, should give plan sponsors and administrators greater flexibility in administering their plans' hardship distribution features and perhaps facilitate the use of an electronic hardship application process, since employers need only obtain summaries of the expenses, and not the actual documentation relating to the expenses, before making a hardship distribution. Plan sponsors and administrators should keep in mind, though, that for these new guidelines to be used, employees must agree to retain the source documents that support their hardship requests and to produce them in connection with a plan audit upon request.

TAKE AWAYS

Employers should determine whether they wish to take advantage of the greater flexibility afforded in the recently-released IRS audit guidance. If so, they should prepare documents that (1) set forth the required participant notification and (2) solicit the necessary summary information to support a hardship distribution request.

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