Transcript: GUIDELINES FOR SUBSTANTIATING SAFE-HARBOR HARDSHIP DISTRIBUTIONS FROM 401(k) AND 403(b) RETIREMENT PLANS

Hello, my name is Steve Shearer and I am an Employee Plans Revenue Agent based in Nashville, Tennessee. I will be discussing the Internal Revenue Service (or the IRS) guidelines for substantiating safe-harbor hardship distributions from Internal Revenue Code sections 401(k) and 403(b) plans.

Let me start by giving you some background on the creation of these guidelines and then I'll provide an overview of the guidelines.

The IRS, Employee Plans received requests from industry stakeholders, such as plan sponsors and their representatives, to clarify how 401(k) and 403(b) retirement plans should substantiate hardship distributions to satisfy the requirements of the Internal Revenue Code and related regulations during a plan audit. In response to these requests, an Industry Issue Resolution Team was formed to produce guidelines to help qualified 401(k) and 403(b) plans. The team consisted of IRS Agents like myself, Senior Technical Advisors, IRS Division Counsel and Associate Chief Counsel, and Department of Treasury Counsel. The Industry Issue Resolution process is discussed in Revenue Procedure 2016-19.

After extensive interaction between the Team and the Industry stakeholders, we issued guidelines on February 23, 2017, regarding hardship distributions from 401(k) plans. On March 7, 2017, we issued a second set of guidelines for hardship distributions from 403(b) plans, which refer to the 401(k) guidelines, because the same set of rules apply to hardship distributions from both types of plans, namely Treasury Regulations Section 1.401(k)-1(d)(3).

Let me now provide an overview of the guidelines.

A qualified retirement plan may but isn't required to allow hardship distributions, but if the plan allows them, the bottom line is that the plan sponsor is ultimately responsible for substantiation of any hardship distributions if the transaction is questioned during an IRS plan audit. The guidelines don't contain any new law under the Internal Revenue Code or Treasury Regulations; rather, they propose a method for sponsors and/or their third party administrators to document hardship distributions in a summary format. The guidelines propose the collection and retention of certain information for the hardship distribution transaction that can be presented by the plan to an IRS agent during an audit.

The 'Background' section of the 401(k) guidelines, quotes a passage from the relevant Treasury Regulation, which is "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 the financial need."

The Regulations go further and list the following six specific safe-harbor types of expenses that are deemed an immediate and heavy financial need:

- 1. certain medical care expenses;
- 2. costs directly related to purchasing a principal residence;
- 3. certain tuition and educational expenses;
- 4. payments to prevent the eviction or foreclosure of the employee's principal residence:
- 5. certain funeral expenses; and
- 6. expenses related to repair damages to the employee's principal residence.

The Treasury Regulations explain each of the above in more detail.

Per the Industry Issue Resolution team's recommendations, the 'Administrative Guidelines' outline the procedures for IRS auditors to follow in verifying hardship distributions in qualified 401(k) and 403(b) plans. The essence of these guidelines is that if a plan receives and retains the original documents that substantiate the hardship distribution, the IRS agent will request and review those records. In the alternative, if a plan sponsor, or their third party administrator, elects to use a 'summary' method to collect and retain the hardship distribution information, the IRS agent will first look to those records.

Under the guidelines, the summary hardship distribution substantiation must include the collection of certain data and specific 'Notifications' to the employee. Those are explained in detail in the 'Attachment I, Part I' to the 401(k) guidelines. For example, the employee must be told that the hardship distribution is taxable and that the amount distributed cannot exceed the need. The hardship distribution recipient must also be told to "preserve source documents and to make them available at any time, upon request, to the employer or administrator."

Part II of 'Attachment I' lists the 'General Information' necessary for all hardship distribution requests, such as the employee's name, the total cost of the event causing the hardship, the amount requested and, finally, a certification from the employee that "the information is true and accurate."

Additional summary information is required depending on the specific type of the hardship; those are listed in the 'Attachment I, Part III' of the hardship distributions guidelines.

If the plan sponsor, or third party administrator, uses the summary method and an IRS agent finds the summary information is "incomplete or inconsistent on its face," the agent will ask for the underlying source documents, which the sponsor or third party administrator would have to get from the employee.

The guidelines also discuss situations where there may be multiple hardship distributions made to the same employee. Although this can occur in some situations, such as on-going educational expenses, if the IRS agent in their professional judgment determines that the multiple hardship distributions are **not** adequately substantiated in the summary format, they may contact their immediate supervisor and request permission to ask the plan sponsor for the source documents.

A primary part of using the summary substantiation method is the plan's level of internal controls for administering the plan. Properly implemented strong internal controls with properly documented summary information should make it easy for a well operated plan to substantiate hardship distributions.

The plan sponsor risks having an operational failure if the hardship distributions aren't properly documented. While it's unlikely the plan would end up losing its tax-qualified status, this could happen if a failure occurs and the sponsor doesn't reach a closing agreement with the IRS if the failure is discovered during an audit. It can also happen if the sponsor discovers the failure on their own and doesn't correct it under the Voluntary Compliance Program.

To recap, the hardship distribution substantiation guidelines tell IRS agents who audit plans how to review any hardship distributions where sponsors have decided to use the summary substantiation method. Plan sponsors and third party administrators should review these guidelines along with their plan procedures and processes to decide how to operate their plans.

The guidelines substantiating safe-harbor hardship distributions will be incorporated into the Internal Revenue Manual.

Thank you for your time today!