

401(k) PLANS

Does This Qualify as a Hardship Distribution? How Involved Should a TPA Be?

When a 401(k) plan allows participants the option to take a safe harbor hardship distribution, it may encourage participants to contribute to the plan because they know they will have funds available if they really need them. It is in the best interest of the plan, though, for the plan sponsor to follow all necessary guidelines for hardship distributions to avoid a qualification issue.

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To the surprise of many third-party administrators (TPAs), investment providers, and recordkeepers, the Internal Revenue Service (IRS) Acting Director for Employee Plans (EP) Examination issued a memorandum to retirement plan examiners in February 2017 that clarified what source documents should be obtained and retained to demonstrate that a requested hardship distribution is deemed to resolve an immediate and heavy financial need. It also provided guidelines to confirm if the source documents included all necessary information. If these guidelines are met, the hardship event is considered to be properly substantiated and the distribution is permissible. If not, an IRS examiner may determine that a qualification failure took place, requiring correction using the Employee Plans Compliance Resolution System (EPCRS). The guidance is to be part of IRM 4.72.2 by February 23, 2019, but the requirements mentioned in the memorandums are

to be applied to exams open on February 23, 2017. [<https://www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf>] A similar memorandum was issued on March 7, 2017, regarding 403(b) plans. It will be part of IRM 4.72.13 by March 7, 2019, but also is effective on the date of the memorandum. [<https://www.irs.gov/pub/foia/ig/spder/tege-04-0317-0010.pdf>] These two memoranda will be referred to throughout this column collectively as the “Memorandum.”

Documentation EP Examiners Expect to Find

The Memorandum mentions the safe harbor hardship distribution reasons for immediate and heavy financial needs permitted by Treasury Regulations Section 1.401(k)-1(d)(3)(iii)(B):

1. Medical expenses for the participant, spouse, children or dependents, or the primary beneficiary of the plan.
2. Purchase of a principal residence (closing costs, down payment, not mortgage payments).
3. Tuition, educational fees, room, and board for up to the next 12 months of post-secondary education. This includes expenses for the participant, spouse, children or dependents, or the primary beneficiary of the plan.
4. Prevention of eviction/foreclosure from/of the employee’s principal residence.
5. Funeral expenses for the participant’s deceased parent, spouse, child, dependent, or the primary beneficiary of the plan.
6. Repair of damage to the participant’s principal residence that would qualify for the casualty deduction under Internal Revenue Code (Code) Section 165.

Examiners determining if one of the above reasons applies are instructed to confirm if the participant provided either source documents (estimates, contracts, bills, and statements) or a summary of the information contained in the source documents. If summary information was provided but was not complete, the examiner can request the source documents. If the summary information appears complete, the examiner will then review the summary.

Responsibility for Retaining Hardship Distribution Documentation

On August 12, 2017, the IRS posted an article on its website titled “It’s Up to Plan Sponsors to Track Loans, Hardship Distributions”(referred to herein as the Article). [<https://www.irs.gov/retirement-plans/its-up-to-plan-sponsors-to-track-loans-hardship-distributions>] The Article notes that the plan sponsor is ultimately responsible for the proper administration of its retirement plan. This includes the hardship distribution records. The following records should be maintained in paper or electronic format:

1. Documentation of the hardship request, review, and approval.
2. Financial information and documentation that substantiates the employee’s immediate and heavy financial need.
3. Documentation to support that the hardship distribution was made in accordance with the plan provisions and the Code.
4. Proof that the actual distribution was made and related Form 1099-R.

The plan sponsor cannot rely on the participant to maintain his or her own records of hardship distributions. Participants may leave employment or fail to keep copies of hardship distribution documentation and or source documents, thereby making records inaccessible during an IRS audit of the plan.

Along with the requirement of an immediate and heavy need, hardship distributions also need to be limited to the maximum distributable amount. This maximum is equal to the employee’s total elective deferrals as of the date of the distribution, reduced by the amount of previous distributions of elective deferrals. If the financial need is higher than the maximum available, then only the maximum can be paid out. The IRS goes on to say in the Article:

Also, electronic self-certification is not sufficient documentation of the nature of a participant’s hardship. IRS audits

show that some TPAs allow participants to electronically self-certify that they satisfy the criteria to receive a hardship distribution. While self-certification is permitted to show that a distribution was the sole way to alleviate a hardship, self-certification isn’t allowed to show the nature of a hardship. (See Treasury Regulations Sections 1.401(k)-1(d)(3)(iv)(C) and (D).) You must request and retain additional documentation to show the nature of the hardship.

The Memorandum provides that the plan sponsor may obtain and retain the necessary source documentation for a hardship distribution; it also provides a compromise option, where the burden of keeping the source information lies with the participant. Certain disclosures must be provided to the participant, and the participant must provide a summary of the information he or she retains.

If either of these two methods is used (and such use is properly demonstrated), the IRS will not look further at whether the hardship distribution was due to a heavy and immediate financial need, but will deem that requirement to be satisfied unless the examiner finds that a participant has received more than two hardship distributions in one plan year. In that case, the examiner may ask why there have been multiple hardship distributions for that participant. The Memorandum provides that, in the absence of “adequate explanation” for the multiple distributions, the examiner (with his or her manager’s approval) may request the source documents from the plan sponsor or TPA. Thus, it is prudent to follow one of the two methods provided in the Memorandum.

As the Memorandum allows for a substantiation option wherein the responsibility to maintain the source documents is the participant’s, assuming certain disclosures are made to the participant and the participant provides the plan sponsor with a summary of the information he or she retained, it seems prudent to use the substantiation method. Otherwise, the Memorandum provides the responsibility to evaluate the hardship distribution falls on the plan sponsor. If this method is chosen, the plan sponsor would be responsible for collecting, reviewing, and retaining the source information to determine whether it supports the participant’s hardship distribution request.

Information That Must Be Provided to the Participant under the Summary of Expenses Method

If the summary of expenses method is used, the plan sponsor must provide the following notifications to the participant who requests the hardship distribution:

1. The hardship distribution is taxable and additional taxes could apply.
2. The amount of the distribution cannot exceed the immediate and heavy financial need.
3. Hardship distributions cannot be made from earnings on elective contributions or from QNEC or QMAC accounts, if applicable.
4. The recipient participant agrees to preserve source documents and make them available at any time, upon request, to the employer or administrator.

And, the participant must provide the plan sponsor with the following:

1. The 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).
2. The amount of distribution requested.
3. A certification by the participant that the information provided is true and accurate.

Does the Plan Sponsor Understand Its Responsibility?

So, this all leads to the question of how the plan sponsor can best understand and meet these requirements so that it does not process a distribution that should not be permitted. Plan sponsors often look to their TPAs for guidance on hardship distributions.

The TPA may provide services to the plan sponsor in relation to administering hardship distributions. For example, a plan sponsor likely will not know the cumulative deferral history for each employee. The employer might not be in a position to review the employee's deferral history and subtract past hardship withdrawals, both of which could be time consuming and require reference to plan records not readily available to the sponsor. The TPA, however, would have access to this information easily in its database due to the census data and trust accounting information that have been collected over their service of the plan, and possibly even earlier if past data was collected at the time of a plan takeover. Therefore, the calculation of cumulative deferrals could be provided to the employer.

It is important that the TPA assist the plan sponsor with the review of the situation and remain objective.

The procedure requires specific items in alignment with the type of hardship, such as medical bills for medical expenses, escrow papers for house purchased, and tuition and book receipts for educational expenses. Perhaps the Specific Information on Deemed Hardship, which is Section III of the Memorandum, could be turned into a checklist that the responsible fiduciary can use to go through the steps to approve a hardship.

If the plan sponsor contacts the TPA for assistance in determining if a situation would qualify as hardship-eligible, the TPA could use the source documentation to make this determination, perhaps by using a procedural checklist modeled from the Memorandum. The TPA then could provide the completed checklist and the amount of financial need and cumulative deferrals to the employer. The employer, then, would have the necessary details to decide the eligibility for hardship, and the TPA would not be making the decision in its discretion. The employer could sign off on the checklist as their approval, and this would document the employer's review of the hardship request. Similarly, the TPA could work with the plan sponsor to create objective criteria that would govern the TPA's granting of hardship requests so that the discretionary aspects of this process would have been predetermined by the plan sponsor.

Conclusion

In closing, it is in the best interest of the plan sponsor to follow all necessary hardship distribution guidelines to avoid a qualification issue. Based on the Memorandum, it seems prudent for the plan sponsor to provide the summary to participants requesting a hardship distribution, and have the participant certify and agree to keep the supporting documentation. If the above guidelines are followed, it seems the IRS agent can pursue the appropriateness of the hardship distribution only if the participant took at least two hardships during the year and the plan sponsor or TPA cannot articulate a viable reason for the repeated distributions. While a paternalistic plan sponsor may want to collect the source documents, be aware that doing so gives the IRS the right to dig deeper to substantiate the plan sponsor's decision to permit the hardship distribution. ■