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Using IRS self-certification rules to streamline hardship distribution administration

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Hardship distributions tend to be one of the most time intensive and difficult parts of plan administration. Recently IRS issued new guidelines for its auditors that provide a more streamlined path for plans to substantiate hardship distributions. This paper provides background on the IRS guidelines and explains how 401(k) plans can take advantage of the new guidance.

Introduction

Most section 401(k) retirement plans allow participants to elect a distribution of some or all of their account prior to termination of employment when the participant experiences a hardship. While employers prefer their employees preserve 401(k) assets for retirement, they recognize that offering access to funds in emergencies helps to encourage employees to save in the first place. Hardship distributions tend to be one of the most time intensive and difficult parts of plan administration, in part because the governing regulations require that the plan ensure the distribution is, in fact, needed to satisfy a hardship. Substantiation of hardship distributions has tended to be paper intensive and can require review of very sensitive and personal information.

Recently the IRS issued new guidelines for its auditors that provide a more streamlined path for plans to substantiate hardship distributions. This new process relies on a combination of self-substantiation by the participant and a technologically advanced approach which can help participants get the needed funds more quickly. The process has a number of advantages for employers, participants, and IRS auditors.

The purpose of this white paper is to lay out the legal background on substantiating hardship distributions, explain the recent guidance from IRS and how 401(k) plans can take advantage of the new guidance, and finally answer common questions about the implications of moving to the streamlined approached to substantiating hardship distributions.

Background on hardship distributions

In exchange for the favorable tax treatment accorded to 401(k) and similar qualified plans, Congress imposed in the Internal Revenue Code (Code) conditions to help ensure that assets set aside in the plan are preserved for retirement. Accordingly, 401(k) plans are restricted from allowing participants under age 59 ½ from taking a distribution while still employed, unless the participant experiences a hardship.

The Code gives very little information on what it means for a distribution to be made "upon hardship of the employee," so the details of what this means are largely filled in by implementing IRS regulations.

The implementing regulations begin by dividing the hardship determination into two requirements.[1] First, the distribution must be made "on account of an immediate and heavy financial need." In other words, there must be some event or condition in the participant's life that has created a financial need that is not insubstantial and that should be addressed immediately. Second, the distribution that the participant is requesting must be "necessary to satisfy that financial need." In other words, the plan should not grant the distribution if the participant clearly has other resources to satisfy the need, nor should the amount distributed exceed the amount needed to address the event or condition.

The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan. The regulations, however, do not require the employer to *guarantee* that the employee has a hardship, just that the plan implements objective standards that can be evaluated on audit.

This white paper, and the new IRS procedures it describes, focuses on the first requirement – that the distribution is on account of an event or condition that has created an immediate and heavy financial need. The regulations allow a plan to set forth its own set of objective and nondiscriminatory standards for evaluating the need, but also provide plans with a series of "safe harbor" events that are deemed to create an immediate and heavy need.

The vast majority of 401(k) plans follow these safe harbor events because they have been preapproved by the IRS:

1. Expenses for medical care
2. Costs directly related to the purchase of a principal residence for the employee
3. Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents
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. Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents
6. Expenses for the repair of damage to the employee's principal residence.

These six events are commonly referred to as the six "safe harbor hardship events." The IRS has proposed to add a seventh safe harbor hardship event for expenses and losses (including loss of income) incurred by the employee on account of a federally declared disaster if the employee's principal residence or principal place of employment is located in the declared disaster area. (For more information on proposed changes to the hardship distribution rules, see the boxed information below.)

Proposed hardship distribution changes

In 2018, Congress passed the Bipartisan Budget Act, which directed the IRS to make changes to the rules for hardship distributions, including removing a requirement that a participant be restricted from making contributions to the plan for six months after a hardship distribution, removing a requirement that a participant take all available loans before a hardship distribution is allowed, and expanding the types of contributions for which a hardship distribution is allowed.

In November 2018, the IRS and the Department of Treasury proposed regulations to implement these changes. The proposed regulations also proposed to add a new type of expense to the list of safe harbor hardship events, relating to expenses incurred as a result of federally declared disasters, which will help prevent delay in getting participants access to needed funds following a disaster that occurs in an area designated by the Federal Emergency Management Agency for individual assistance.

The hardship distribution changes are still pending as this white paper is being published, but because they largely relate to the second requirement of the hardship distribution rules—that the distribution is necessary to satisfy the financial need—they do not affect the issues described in this white paper, which relate to the procedures to substantiate that the participant has a hardship event.

IRS industry resolution process for substantiation of safe harbor hardship events

While the 401(k) regulations lay out the kinds of events or conditions that are deemed to create an immediate and heavy financial need, the regulations do not explain how a plan administrator should *substantiate* that such a hardship occurred. In fact, in 2004, when the IRS updated the 401(k) regulations, the IRS was asked to provide specific guidance on documentation and verification requirements for hardship distributions, and specifically declined to do so.[2] Instead, the IRS simply stated that plans are required by the Code to keep the records necessary to demonstrate compliance with the plan qualification requirements.[3]

Traditionally, many plans have collected and reviewed documentation such as original invoices and health care and funeral bills, but this process is slow, cumbersome, invasive, and expensive. This often requires a human being to review each and every document, which must be scanned or faxed.

If the review is done by the employer, the participant must provide personal and sometimes embarrassing information and documents to their employer's human resource department. And, unfortunately, reviewing original invoices often adds significant delay to approving a distribution – meaning that the kind of distribution that takes the longest to approve is the one distribution that should happen quickly, because by definition the participant has an immediate and heavy financial need for the funds.

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Over time, to try to address the burdensome hardship process, other plans began to use a streamlined process in which the plan collects the *information* on those documents, rather than the documents themselves, and has the participant certify that the information is correct.

The IRS created significant confusion in 2015 when it released a newsletter article on hardship and loan compliance. The article included guidance that has never been officially provided – and a newsletter is not considered official guidance – regarding the documentation requirements for hardship distributions. Shortly thereafter, groups representing plan sponsors and 401(k) service providers wrote to the IRS to seek clarification and guidance about the administration of the hardship distribution rules.

Then the IRS did something surprising and encouraging. IRS officials initiated a process called the Industry Issue Resolution program. This program resolves frequently disputed or burdensome tax issues that affect a significant number of business taxpayers through the issuance of guidance.[4] IRS solicits suggestions for issues from taxpayers, representatives and associations for the program and will typically meet with representatives of associations whose members are affected by the issue. While this program is commonly used, it had never to that point been used by the IRS's Tax Exempt and Governmental Entities division to resolve a qualified plan issue.[5]

Application to 403(b) plans

Section 403(b) plans are also generally restricted from allowing participants access to their own contributions while still employed, except in the case of hardship. There are some differences in the rules, but the safe harbor events described in this white paper apply equally to 403(b) plans, and thus so do the new IRS self-certification substantiation procedures. Accordingly, the central points in this white paper are applicable to 403(b) plans, just like 401(k) plans.

Trade associations representing all segments of the retirement plan industry met multiple times with IRS officials in person and by phone. The groups suggested allowing a process under which the plan or its service provider collects from the participant the same information that would be reviewed from any paper documentation regarding the hardship. In essence, the participant is self-certifying the hardship, but doing so in a way that provides exactly the information that would be reviewed and stored by the plan or its service provider. Because this information is collected and stored systematically and consistently in the plan's records, this process actually makes it easier for the IRS to review the plan's internal procedures and controls upon audit.

I personally participated in the meetings with IRS and Treasury officials, and throughout the process two things were clear. First, government officials were genuinely interested in providing guidance that could streamline the administration of hardship distributions. Second, they were focused on providing a balanced approach that ensured IRS auditors had a straightforward way to review the plan's internal procedures and controls.

IRS guidance allows self-substantiation of hardship distributions

The resulting guidance, first issued as a February 23, 2017 memorandum from the director of Employee Plans Examinations[6] and now officially incorporated into the Internal Revenue Manual used by IRS auditors,[7] is big leap forward in plan administration.

The guidance provides that a plan should, prior to making a distribution, obtain either original source documents (such as estimates, contracts or bills from third parties) or – and this is the part that is new – collect from the participant a summary of the information contained in source documents. For example, rather than collecting an invoice for college tuition, the plan would collect the same information that it would pull from the invoice: The name of the student and his or her relationship to the student, the name and address of the college, the types of expense involved (i.e. tuition, room and board), and the period covered by the payments (i.e. a semester). The big advantage of this approach is that is can be done completely electronically and thus can be processed quickly.

What the guidance states

If the plan elects to collect the information on the source documents, the plan must provide notice to the participant that the hardship distribution is taxable and additional taxes could apply, that the amount of the distribution cannot exceed the immediate and financial need, and that hardship distributions cannot be made from earnings on elective contributions or from QNEC or QMAC accounts, if applicable.[8] In addition, the participant must certify that the information provided is true and accurate and must agree to preserve source documents and to make them available, upon request, to the employer or plan administrator.

The guidance states that if a plan is audited, the auditor should review the plan's records to ensure that the relevant information was collected, and the proper notice was provided. The auditor does not ask the plan to obtain any of the source documents unless the information in the plan's records for a hardship distribution is incomplete or inconsistent on its face or where there are employees who have received more than two hardship distributions in the year. In that case, the auditor may ask the employer for an explanation or ask the plan to ask participants for the source documents.

The guidance also states that if a third-party administrator obtains a summary of information, the auditor should determine whether the third-party administrator provides a report or other access to data to the employer, at least annually, describing the hardship distributions made during the plan year. This requirement was discussed at length during the meetings with IRS officials to ensure plan fiduciaries have access to information to watch out for patterns suggesting misuse of hardship distributions by their employees.

Perhaps most helpful of all, the guidance includes an attachment that lays out the exact information that plans should collect for each safe harbor hardship event. Access the list via the IRS guidance issued in 2017.

What does this mean for plan sponsors?

The guidance is not a pronouncement of law, but rather provides rules for IRS auditors to follow. That said, if a plan follows the approach described in the guidance, an IRS auditor is instructed to consider the plan in compliance with the hardship distribution rules.

Plans are not required to use the new streamlined hardship distribution procedures. And the procedures are intended only for plans that follow the safe harbor hardship events, as most 401(k) plans do.

What the IRS guidance does facilitate, for the first time, is a procedure for self-certification by the participant who has a hardship need. Importantly, while this process does allow for self-certification, the new procedures are not simply a "check the box" for the participant; the participant must provide specific information from the source documents and this specific information will be retained in the event of an audit.

The procedures also suggest employers should pay attention to any participant that requests more than two hardship distributions in a year to ensure such requests are legitimate (for example, because the participant is paying for college tuition on a quarterly school calendar). In short, even if a plan decides to move to the new self-certification process, there will still be some oversight responsibility and a record for the plan's auditors and the IRS to review if needed.

Since the guidance was released in 2017, a number of service providers have begun to offer the streamlined, largely online, hardship distribution procedures, and employers are increasingly using these new procedures. For employers who are looking to reduce the burden of hardship distribution administration, the new IRS-approved process is worth a look.

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The frequently asked questions and answers on the following page may be helpful to employers as they consider whether this approach is appropriate for their companies.

Frequently asked questions

My plan uses the safe harbor hardship events, but also allows non-safe harbor hardship distributions. Does the guidance apply?

Answer: By its terms, the IRS guidance applies only to distributions that are deemed to be on account of an immediate and heavy financial need, i.e. the safe harbor hardship events. For distributions that are not made under the safe harbor hardship events, it is recommended that the plan consult counsel.

The participant must agree to preserve source documents and to make them available at any time, upon request, to the employer or administrator. What happens if the IRS asks for the source documents and they are not produced by the employee, or the employee has since terminated employment and cannot be located?

Answer: This exact scenario was discussed at length with the IRS during the Industry Issue Resolution process, and IRS officials acknowledged and understood that the employee cannot be *forced* to retain the documents and in some cases the employee may not be available at all (e.g. has terminated employment). IRS officials also understood that even if the plan obtains source documents, those can be forged if a participant really wants to do so. The guidance directs IRS auditors to ask for source documents only if the information provided by the employee was "incomplete or inconsistent on its face," or if there were more than two hardship distributions in a year, only if there is no adequate explanation and only with the manager approval. In any event, the guidance does not require the plan to *guarantee* that the source documents exist or direct the agent to disqualify the plan if an employee cannot produce the documents. Rather, the IRS auditor is likely to examine whether the *process* the plan used is consistent with the guidance.

Is there a precedent for this streamlined hardship distribution process?

Answer: Yes. The federal government's own 401(k) plan, the Thrift Savings Plan (TSP), uses a similar online process which does not require providing source documents regarding the hardship event. Like the new IRS procedures for private 401(k) plans, the TSP does not require a federal employee to submit documentation to the TSP to substantiate the financial hardship. The federal employee must certify on the TSP withdrawal form that he or she has a genuine financial hardship and the reason for the financial hardship withdrawal.

Do I need to amend my plan to use the streamlined hardship distribution process?

Answer: It depends on the terms of the plan document, but probably not. Most plan documents set forth the events for which a hardship distribution may be granted, but do not describe exactly how the plan administrator should substantiate the hardship before allowing a distribution. Instead, plan documents tend to provide the plan administrator or other named fiduciary broad discretion to administer the plan. In any event, your plan document should be reviewed and counsel consulted, if necessary.

The IRS guidance requires that if a third-party administrator obtains the summary of information contained in source documents, that third-party administrator provides a report or other access to data to the employer, at least annually, describing the hardship distributions made during the plan year. What should be done with this data?

Answer: The IRS guidance does not require the plan fiduciaries do anything specific with the hardship distribution data, except insofar as it suggests further examination may be necessary if a participant requested more than two hardship distributions in one year. That said, like all aspects of plan administration, the plan's fiduciary should be periodically monitoring the administration of the plan and the behavior of participants, including contributions, investment allocation, loans, and distributions. Similar to other reports and data a plan fiduciary receives or has access to from the plan's service providers, the key is a prudent process to review the data that the fiduciary concludes is relevant to proper plan administration, consult experts where necessary, and act in accordance with the plan document and the law, and solely in the interest of the plan and its participants.

What information does the IRS require from participants in the self-certification process?

Answer: For the IRS list of information required to be collected, please see the IRS guidance issued in 2017.

[1] The regulations governing hardship distributions can be found at 26 C.F.R. § 1.401(k)-1(d)(3).

[2] 78 Fed. Reg. 78144, 78148 (Dec. 29, 2004).

[3] The general requirement to keep adequate records to demonstrate compliance with the Internal Revenue Code is contained in Code section 6001. It requires taxpayers to keep such records as the Secretary of the Treasury may require to show whether or not the taxpayer is liable for tax. In the case of a qualified plan, which is eligible for favorable tax treatment, this means demonstrating compliance with the rules in Code section 401.

[4] The Industry Issue Resolution program is described in Revenue Procedure 2016-19.

[5] Internal Revenue Service, Industry Issue Resolution Program, December 2016.

[6] Memorandum for Employee Plans (EP) Examination Employees from Thomas J. Petit, Acting Director, EP Examination (Feb. 23, 2017), Control Number TE/GE-04-217-0008.

[7] Internal Revenue Manual § 4.72.2.7.4.1 (Sept. 5, 2017).

[8] Because of recent changes made by the Bipartisan Budget Act of 2017, these restrictions are no longer required, unless the plan decides to impose them.

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