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EMPLOYEE BENEFITS AND
EXECUTIVE COMPENSATION

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New IRS Guidance for Hardship Withdrawals

On February 23, 2017, the IRS issued a memorandum (https://www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf) providing new guidelines for IRS auditors reviewing the propriety of hardship withdrawals from 401(k) plans. The memorandum revises the expectations established in an earlier IRS newsletter, which stated that plan administrators should make arrangements to retain documentation substantiating the legitimacy of the claimed hardship expense. Under the revised guidelines, auditors can accept a system that requires participants to retain this documentation and provide it on request, if certain disclosures are provided and if the participant provides specified information about the expense to the plan.

The new memorandum is informal guidance, but plan administrators who fail to adhere to the memorandum's guidelines and end up facing an IRS audit at best have increased their risk of time-consuming and potentially expensive disputes with the auditor. If the IRS finds that the plan in fact made payments that were not permitted under Section 401(k) of the Code and/or the terms of the plan, the IRS may require corrective action and potentially impose monetary sanctions. Accordingly, voluntary adherence to the guidelines is advisable.

Hardship Withdrawals

As a general matter, a participant cannot access amounts contributed to a 401(k) plan on a pre-tax or Roth basis while he or she remains employed, unless he or she has attained age 59½, is disabled (as defined by the Internal Revenue Code), is on military duty and meets certain conditions, or has incurred a qualifying hardship. The IRS has pre-approved a list of events that qualify as "hardships" for this purpose, and most plans that allow hardship withdrawals require the hardship withdrawal to fall into one of the pre-approved categories. If a plan makes a payment that it characterizes as a hardship withdrawal, the plan must be prepared to substantiate that the withdrawal was in fact for a qualifying hardship expense.

Substantiation Standards Set by the New Memorandum

Under the new memorandum, plans have a choice of requiring and retaining actual documentation substantiating the claimed hardship expense, or requiring the participant to provide summary information about the expense while the participant retains the actual documentation. Accordingly, a plan administrator (or its recordkeeper) should do the following:

If Requiring Source Documentation

- Require the participant to complete a hardship request form that will ensure all information listed by the IRS as desired for a given hardship event, along with any other information required by the plan's terms and IRS regulations, has been provided to the plan.
  - Although the IRS memorandum's specific list of information applies only to plans obtaining summary information in lieu of actual substantiating documentation, the documentation provided by a given participant may or may not be enough to provide all the information that the plan needs to validate the distribution. Accordingly, a plan's hardship withdrawal request form should spell out all information needed, so that the plan is not at the mercy of imprecise bills or other documents if it needs to prove to an auditor that a withdrawal was justified.
- Obtain and retain copies of the supporting source documentation.
- Review the request form and the supporting documentation to confirm facial compliance with IRS standards prior to making payment.

PRACTICE LEADER
Paul W. Holloway
pholloway@hselaw.com

PARTNERS
Thomas J. Hurley
thurley@hselaw.com
Christopher M. Potash
cpotash@hselaw.com
Mark R. Wilson
mwilson@hselaw.com

COUNSEL
Cody R. Braithwaite
cbraithwaite@hselaw.com
Leslie E. DesMarteau
ldesmarteau@hselaw.com
Lisa G. Pelta
lpelta@hselaw.com
Joseph E. Simpson
jsimpson@hselaw.com
Lori J. Stone
lstone@hselaw.com

ASSOCIATES
Colleen M. Allen
callen@hselaw.com
Emily C. Ayers
eayers@hselaw.com
John W. Brill
jbrill@hselaw.com
Alexandra Lugo
alugo@hselaw.com
Jesse A. St.Cyr
jstcyr@hselaw.com

BENEFITS LITIGATION COUNSEL
John P. Bringewatt
jbringewatt@hselaw.com
Megan K. Dorritie
mdorritie@hselaw.com
Erika N. D. Stanat
estanat@hselaw.com

hselaw.com

HSE Harter Secrest & Emery LLP
ATTORNEYS AND COUNSELORS

If Requiring a Summary

- Provide participants requesting a hardship withdrawal with a notification:
  - That the hardship distribution is taxable and additional taxes could apply;
  - That the amount of the distribution cannot exceed the immediate and heavy financial need;
  - That hardship distributions cannot be made from earnings on pre-tax or Roth contributions (or, if relevant, from qualified nonelective contribution and qualified matching contribution accounts); and
  - That the participant must retain the substantiating documents and make them available upon request, at any time, to the plan administrator or employer.
- Require the participant to complete and certify the accuracy of a hardship request form that will ensure that all of the summary information listed by the memorandum for the relevant hardship event (along with any other information required by the plan's terms and IRS regulations) has been provided to the plan.
- Review the request form to confirm facial compliance with IRS standards prior to making payment.

It is worth noting that even if a plan requires the participant to provide the actual substantiating documentation, a number of the precautions required by the IRS for plans that only obtain summaries are nonetheless appropriate. For example, participants should be required to certify the accuracy of their claims, and should be warned of the tax consequences of taking a hardship withdrawal.

Ongoing Oversight Expectations

The memorandum instructs an auditor to determine whether a plan recordkeeper that collects summary information rather than actual documentation provides a report on hardship withdrawal activities or other access to the summary information to the employer at least annually. While the memorandum does not specify any action to be taken if the recordkeeper does not do so, the implication is that an employer that does not receive and review this data may have lax hardship oversight and merit more extensive review to determine whether withdrawal activity has been appropriately limited to valid hardship events.

In contrast, the memorandum does not discuss whether the employer or plan administrator of a plan that requires actual documentation rather than a summary should be receiving annual summaries of hardship activities. Presumably, the IRS expects that the requirement that a participant provide actual documentation will reduce the risk that a participant could receive payment under circumstances that are facially improper.

Ultimately, however, regardless of whether a plan requires actual documentation or summary information, the plan administrator needs to do the following:

- Understand the level of review given to summaries or substantiating documentation, whichever is applicable, and be comfortable that the individuals checking hardship withdrawal requests are likely to identify facial inconsistencies or obvious fraud.
- Periodically audit the hardship withdrawal process.
  - If summaries are used, consider requesting the substantiating documentation for a sample set of withdrawals.
- Pay special attention to repeat users of the hardship withdrawal feature, especially if two hardship withdrawals occur in the same year.
  - Plans that only require a summary in lieu of actual documentation should note that an IRS auditor is more likely to ask for back-up documentation in the case of a second withdrawal in a single year, unless an adequate explanation is available and managerial approval was provided.

Next Steps

While the new memorandum offers some additional procedural flexibility, it does not allow plan administrators to neglect their responsibility to establish procedures that can reasonably be expected to prevent improper payments from the plan. Plan administrators need to:

- Review the procedures they have in place;
- Determine whether the disclosures provided and documentation retained is likely to satisfy an IRS auditor under the memorandum's standards;
- Determine whether the review that takes place at the time a payment is made is likely to identify an inappropriate or fraudulent request;
- Make improvements as necessary; and
- Periodically revisit the procedures and record retention for hardship approvals to ensure that they continue to function as intended.

For More Information

As always, please feel free to contact a member of the Employee Benefits & Executive Compensation group for more information about the items discussed in this newsletter, or for assistance in other matters.■

HSE Harter Secrest & Emery LLP
ATTORNEYS AND COUNSELORS

ROCHESTER
1600 Bausch & Lomb Place
Rochester, NY 14604-2711
585.232.6500

BUFFALO
50 Fountain Plaza, Suite 1000
Buffalo, NY 14202-2293
716.853.1616

ALBANY
111 Washington Ave., Suite 303
Albany, NY 12210-2209
518.434.4377

CORNING
8 Denison Parkway East, Suite 403
Corning, NY 14830-2638
607.936.1042

NEW YORK
733 Third Avenue
New York, NY 10017
646.790.5884