# Substantiating 401(k) Hardship Withdrawals Upon IRS Exam

The IRS has noted on its website page Hardship Distribution Tips from EP Exam that despite the growing trend for plans to grant hardships to participants who electronically apply for hardship distributions using their PIN and self-certifying that they meet the hardship criteria, the IRS examiner will still look for the documentation to ensure that the plan made hardship distributions according to its terms and the law. This electronic self-certification process does not relieve the plan sponsor's need for verification and recordkeeping.

The IRS has recently issued guidance to examiners regarding what information the examiner should look for when verifying 401(k) safe-harbor withdrawals.

## A brief review of the rules

A retirement plan may, but is not required to, provide for hardship distributions. Many plans that provide for elective deferrals also provide for hardship distributions. If a 401(k) plan provides for hardship distributions, it must provide the specific criteria used to make the determination of hardship. A 401(k) hardship withdrawal must be made on account of an immediate and heavy financial need of the employee, and the amount must be necessary to satisfy the financial need.

Certain expenses are deemed to be immediate and heavy, including: (1) certain medical expenses; (2) costs relating to the purchase of a principal residence; (3) tuition and related educational fees and expenses; (4) payments necessary to prevent eviction from, or foreclosure on, a principal residence; (5) burial or funeral expenses; and (6) certain expenses for the repair of damage to the employee's principal residence.

### The IRS examiner

In determining whether a hardship withdrawal was made on account of a deemed immediate and heavy financial need, the IRS examiner will look for whether the employer or third-party administrator, prior to making a distribution, obtained: (a) source documents (such as estimates, contracts, bills and statements from third parties); or (b) a summary (in paper, electronic format, or telephone records) of the information contained in source documents.

If a summary of source documents was used, the examiner will be looking for whether or not the following disclosures were made to the participant:

- The hardship distribution is taxable and additional taxes could apply.
- The amount of the distribution cannot exceed the immediate and heavy financial need.
- Hardship distributions generally cannot be made from earnings on elective deferrals or from QNEC or QMAC accounts, if applicable.
- Hardship distribution cannot be made available from Safe Harbor Non-Elective Contributions or Safe Harbor Matching Contributions before age 59½ .
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.

Note:– *most plans sponsors and third party administrators are likely to be in compliance with the first four bullet points above but may not be with the last bullet point. There always has been a conflict for employers between their role to operate the* *plan according to regulations and its provisions, and their reluctance to invade participant's privacy particularly regarding personal financial information.*

The IRS examiner will review available source documentation to verify that such documentation substantiates the hardship withdrawal.

If summary information is provided, the IRS examiner will review the items contained in the attachment to the exam guidance vs the information provided in the summary. The examiner can request the source documentation if he/she believes the summary information is incomplete or inconsistent on its face.

In addition, even if the summary documentation is complete and consistent with the distribution but the participant has received more than two hardship withdrawals in a plan year, the IRS examiner may ask for source documentation.

If the third-party administrator obtains summaries of information, the IRS examiner will determine if the plan sponsor receives a report or other access to data at least annually describing the hardship distributions made during the plan year.

Bottom line for Plan Sponsors:

Never forget that even though a plan sponsor may outsource plan administration, the plan sponsor is ultimately responsible unless the third-party administrator agrees to accept fiduciary responsibility. Even if the third-party administrator accepts fiduciary responsibility, the plan sponsor has a duty to monitor the third-party administrator.

Plan sponsors should review their hardship withdrawal process to ensure that source documentation is preserved, especially if electronic verification is used. In addition, communication material should note that the participant must retain source documentation.

Confirm that you either receive a report of hardship distributions or are able to access your plan's recordkeeping system to review such information.