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IRS Updates Substantiation Procedures for Hardship Distributions

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Hardship distributions allow qualified plan participants to withdraw funds from their qualified plan accounts without separating from service when participants experience an immediate and heavy financial need. Before February 2017, IRS auditors applied varying requirements for plan sponsors to collect paper documents substantiating the hardships of participants who received hardship distributions, despite there being no formal guidance requiring such documentation. In February 2017, the IRS issued a memorandum (the "2017 Memorandum") to its auditors stating that qualified plan sponsors were required to collect paper documentation to substantiate distributions made on account of safe-harbor hardships.

A safe-harbor hardship is one of the six distribution reasons, enumerated in the 401(k) regulations, that the IRS has determined meets the requirements of being an immediate and heavy financial need. Plan sponsors may allow hardship distributions for other reasons (if the plan so provides), but must make an independent assessment that the distribution for the reasons requested by the participant is necessary to meet an immediate and heavy financial need.

Recently, the IRS updated the Internal Revenue Manual ("IRM") to incorporate the principles from the 2017 Memorandum. issued additional sub-regulatory guidance to plan sponsors that formalizes the requirements imposed on plan sponsors for substantiating hardship distributions. The guidance can be found here. The primary takeaway for plan sponsors is that failing to maintain the required records is a qualification failure that should be corrected using the Employee Plans Compliance Resolution System ("EPCRS").

Plan sponsors now have two methods to substantiate hardship distributions – the traditional method (which had previously been set forth in the IRM) and the summary substantiation method (from the 2017 Memorandum), which applies only to safe-harbor hardship distributions. If using the traditional method, plan sponsors must maintain each of the following in either paper or electronic format:

- Documentation of the hardship request, review, and approval;
- Financial information and documentation that substantiates the employee's immediate and heavy financial need;
- Documentation to support that the hardship distribution was properly made according to applicable plan provisions and the Internal Revenue Code; and

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- Proof of the actual distribution made and related Forms 1099-R.

Alternatively, plan sponsors may use the summary substantiation method for safe-harbor distributions. The advantage of this method is that the participant receiving the hardship distribution maintains the records to substantiate the hardship distribution rather than the plan sponsor. To utilize the summary substantiation method, the plan sponsor must notify the participant seeking a hardship of each of the following:

- 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 cannot be made from earnings on elective contributions or from QNEC or QMAC accounts, if applicable; and
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.

In addition to notifying the participant seeking a hardship distribution of the above, the plan sponsor must also collect certain information from the participant, which varies depending on each type of safe-harbor hardship the participant incurs. That information is set out in IRM Exhibit 4.72.2-2.

None of the IRM requirements for substantiating hardship distributions have been set forth in formal regulations that have been subject to notice and comment. But as stated in the 2017 Memorandum, the IRS believes substantiation that a distribution is for one of the safe-harbor hardships is required to determine that a hardship distribution is deemed to be on account of an immediate and heavy financial need. As a result, plan sponsors seeking to avoid disputes with IRS auditors may wish to follow the hardship substantiation requirements outlined here.