

## Informal IRS Guidance on Substantiation of Hardship Distributions

Earlier this year, the IRS issued new guidance on the substantiation of hardship distributions.<sup>1</sup> As background, 401(k) plans may allow employees to receive a distribution that is necessary to satisfy an immediate and heavy financial need. The regulations include a safe harbor for certain kinds of expenses that are automatically deemed to be in the nature of a heavy and financial need, such as tuition or funeral expenses. While the regulations specifically allow employers to rely on employee representations that a hardship distribution is financially necessary, the regulations are silent on whether employee representations can be relied upon to satisfy the safe harbor concerning the nature of the hardship.

In the past, the IRS has informally said employers should not rely on an employee's self-certification concerning the nature of a hardship; instead, employers were instructed to retain records documenting the hardship request, including "financial information and documentation that substantiates the employee's immediate and heavy financial need." The IRS' rationale was that these records could become inaccessible during an audit if the records are maintained only by employees and not the employer.<sup>2</sup>

In February 2017, the IRS issued a memorandum for its Employee Plans examiners which softened its earlier guidance. Under the memorandum, employers can request either source documents (e.g., bills or contracts) or rely on a summary of the information contained therein to substantiate a hardship. However, if an employer relies on a summary, additional requirements must be met:

- The employee must be notified of certain information concerning the distribution, including that the employee agrees to preserve source documents and make them available upon request.
- The summaries relied upon must contain general information about the hardship, as well as certain information specific to the nature of the hardship.
- If a third-party administrator obtains the summaries, it should report or provide access of hardship data made during the plan year to the employer at least annually.

Although it appears the IRS will permit employers to rely on employee provided summaries, there are still situations when an IRS examiner may demand source documents. Specifically, an examiner may request source documents from the employer where the notification or summaries are incomplete or inconsistent, or where more than two hardship distributions were received in a plan year by an employee in the absence of an adequate explanation.

The IRS memorandum is not legally binding. Nonetheless, it provides additional comfort to plans that may wish to rely on employee statements concerning hardships. That said, employers should carefully weigh the ease of administration that accepting summaries provides against the challenges that may arise in the event an IRS examiner requests source documents that the employee no longer retains.

*Not intended as legal advice.*

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<sup>1</sup> Substantiation Guidelines for Safe-Harbor Distributions from Section 401(k) Plans (February 23, 2017), available at <https://www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf>.

<sup>2</sup> Employee Plans News Issue No. 2015-4, available at [http://op.bna.com.s3.amazonaws.com/pen.nsf/id/krkl-9v6rgu/\\$File/eptn\\_2015\\_4.pdf](http://op.bna.com.s3.amazonaws.com/pen.nsf/id/krkl-9v6rgu/$File/eptn_2015_4.pdf).