

# Compensation and Benefits Insights

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## “Softening” the Hardship Substantiation Requirements? The IRS Issues Examination Guidelines on Hardship Distribution Substantiation

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The Internal Revenue Service (“IRS”) recently issued a [memorandum](#) (the “Memo”) to IRS employee plans examination employees addressing the substantiation guidelines IRS employees should follow when examining whether a hardship distribution under a Code<sup>1</sup> Section 401(k) (“401(k)”) plan is deemed to be on “account of an immediate and heavy financial need” under the 401(k) safe-harbor standards stated in the Income Tax Regulations with respect to Code Section 401(k) (the “401(k) Regulations”). The Memo sets forth steps that IRS employees should follow depending on the method used by the employer (or third party administrator) to substantiate the immediate and heavy financial need, as described more fully below. While the Memo may not be relied upon a legal precedent, it offers valuable insight into the IRS’s current position on the hardship distribution substantiation requirements.

### Background

Generally, 401(k) plans may provide that an employee can receive a distribution of elective contributions from the plan on account of hardship. A distribution is made on account of hardship only if both prongs of a two-part test are satisfied. The first prong requires that the distribution be made “*on account of an immediate and heavy financial need*” of the employee, and the second prong requires that the distribution be “*necessary to satisfy the financial need.*” The second prong also includes a requirement that the employee “lack other resources” to meet the need.

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<sup>1</sup> The Internal Revenue Code of 1986, as amended.

### Our Practice

We advise public, private, taxable and tax-exempt clients on a wide variety of issues related to the design, preparation, communication, administration, operation, merger, split-up, amendment and termination of all forms of employee benefit plans and executive compensation programs and related funding vehicles. The firm has defended clients in significant high-profile ERISA litigation matters, including 401(k) plan “stock drop” cases and other breach-of-fiduciary-duty class actions.

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A distribution is “deemed” under the 401(k) Regulations to be on account of an immediate and heavy financial need for purposes of the first prong of the test if it is for one or more of the following:

1. Certain expenses for medical care;
2. Costs directly related to the purchase of a principal residence;
3. Certain payments for tuition and related fees for post-secondary education;
4. Payments necessary to prevent eviction from the employee’s principal residence or foreclosure of the mortgage on that residence;
5. Certain payments for burial or funeral expenses; or
6. Certain expenses for the repair of damages to the employee’s principal residence.

## **Substantiation Requirements**

The 401(k) Regulations provide guidance for an employer to follow to substantiate that a distribution is “*necessary to satisfy the financial need*” for purposes of the second prong of the hardship test (either by relying on employee representations to that effect, absent the employer’s actual knowledge to the contrary, or by satisfying a safe harbor set forth in the regulations). However, the 401(k) Regulations do not provide any guidance for an employer to follow to substantiate that the distribution is made “*on account of an immediate and heavy financial need*” for purposes of the first prong of the test.

First, the Memo clarifies that substantiation that a distribution is for one of the above items is required to determine that a hardship distribution is deemed to be on account of an immediate and heavy financial need.

In addition, the Memo notes that substantiation can be achieved in one of two ways – by the employer (or third party administrator) either obtaining (a) source documents (such as estimates, contracts, bills and statements from third parties) substantiating the expense, or (b) a summary (in paper, electronic format, or telephone records) of the information contained in such source documents, subject to certain additional requirements described below.

### *Source Documents*

If the employer (or third party administrator) obtains source documents to substantiate the immediate and heavy financial need, the Memo instructs the IRS examination employee to simply review the documents to determine if they properly substantiate the need.

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## *Summary of Source Documents*

However, if the employer (or third party administrator) obtains a summary of source documents to substantiate the immediate and heavy financial need, the Memo notes that the employer (or third party administrator) will also need, prior to making the hardship distribution, to provide a notification to the employee regarding the hardship, and that the summary must set forth specific information related to the hardship. In addition, if a third party administrator (as opposed to the employer) obtains the summary, the third party administrator must provide a report, or other access to data, to the employer at least annually describing the hardship distributions made during the plan year. Finally, if a summary of source documents is obtained, the Memo instructs the IRS examination employee to take a number of additional steps to confirm that the distribution is “on account of an immediate and heavy financial need.”

## NOTICE REQUIREMENT

If the employer (or third party administrator) obtains a summary of source documents to substantiate the immediate and heavy financial need, then prior to making the hardship distribution, the employer (or third party administrator) will need to provide a notification to the employee with the following information:

- 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 elective contributions or from QNEC or QMAC accounts, if applicable; and
- that the employee agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.

## INFORMATION REQUIRED IN SUMMARY

If the employer (or third party administrator) obtains a summary of source documents to substantiate the immediate and heavy financial need, the Memo sets forth (on Attachment 1 to the Memo) specific information related to the hardship that must be included in the summary, including general information for all hardship requests (such as the employee’s name and the amount of the distribution requested) as well as specific information tailored to the type of hardship request.

## ADDITIONAL EXAMINATION STEPS

If the employer (or third party administrator) obtains a summary of source documents to substantiate the immediate and heavy financial need, the Memo instructs the IRS examination employee to take the following additional steps in connection with the distribution:

1. Determine whether the employer (or third party administrator) provides the required employee notifications (as described above);

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2. Review the summary to determine whether it contains the relevant information for the type of hardship (as described above in “INFORMATION REQUIRED IN SUMMARY”);
3. If the notification or information in the summary is incomplete or inconsistent on its face, the IRS employee may ask for source documents from the employer (or third party administrator) to substantiate the distribution;
4. If an employee has received more than two hardship distributions in a plan year, then, absent an adequate explanation for the multiple distributions (such as the need for follow-up medical or funeral expenses or tuition paid on a quarterly school calendar) and with managerial approval, the IRS employee may ask for source documents from the employer (or third party administrator) to substantiate the distributions;
5. If a third-party administrator obtains the summary, determine whether the third-party administrator provided a report or other access to data to the employer, at least annually, describing the hardship distributions made during the plan year.

## Effective Date

The Memo is effective on February 23, 2017, and IRS employees are instructed to apply the Memo to examinations open on the effective date. In addition, the Memo will be incorporated into the Internal Revenue Manual by February 23, 2019.

King & Spalding would be happy to assist you with any questions you have about the 401(k) hardship distribution requirements.

## April and May 2017 Filing and Notice Deadlines for Qualified Retirement and Health and Welfare Plans

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Employers and plan sponsors must comply with numerous filing and notice deadlines for their retirement and health and welfare plans. Failure to comply with these deadlines can result in costly penalties. To avoid such penalties, employers should remain informed with respect to the filing and notice deadlines associated with their plans.

The filing and notice deadline table below provides key filing and notice deadlines common to calendar year plans for the next two months. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is generally delayed until the next business day. Please note that the deadlines will generally be different if your plan year is not the calendar year. Please also note that the table is not a complete list of all applicable filing and notice deadlines (including any available exceptions and/or extensions), just the most common ones. King & Spalding is happy to assist you with any questions you may have regarding compliance with the filing and notice requirements for your employee benefit plans.

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Deadline	Item	Action	Affected Plans
April 1	Age 70 ½ Distribution Requirements	Deadline for plan administrator to distribute prior year's required minimum distribution for any terminated employee who reached age 70 ½ or older during the prior year.	Qualified Retirement Plans*
April 15	Excess Deferrals	Deadline for plan to distribute prior year's deferrals in excess of Internal Revenue Code (IRC) §402(g) annual dollar limit and related earnings.	401(k) Plans
April 16  (105 days after the end of the plan year)	PBGC 4010 Filing	<p>Deadline for contributing sponsors (and each controlled group member) to file PBGC Form 4010 if:</p> <p>1) Any single-employer plan in the contributing sponsor's controlled group had a prior year adjusted funding target attainment percentage (AFTAP) of less than 80%;</p> <p>2) Any single-employer plan in the contributing sponsor's controlled group fails to make a required installment or other required payments to a plan, and as a result, a lien is imposed pursuant to ERISA section 303(k)(1) or IRC section 430(k)(1); or</p> <p>3) The IRS has granted funding waivers of more than \$1 million to any single-employer plan in the contributing sponsor's controlled group and any portion of such waiver is still outstanding.</p>	Defined Benefit Plans
April 30  (no later than 120 days after the end of the plan year)	Annual Funding Notice	Deadline for the plan administrator to provide a plan funding notice to the PBGC, to each plan participant and beneficiary and to each employer that has an obligation to contribute under the plan.	Defined Benefit Plans

\* Qualified Retirement Plans include all defined benefit and defined contribution plans that are intended to satisfy Internal Revenue Code §401(a).

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Deadline	Item	Action	Affected Plans
May 14  (within 45 days after the close of the first quarter of plan year)	Benefit Statements for Participant-Directed Plans	Deadline for plan administrator to send benefit statement for the first quarter of the plan year to participants in participant-directed defined contribution plans.	Defined Contribution Plans that allow participants to direct investments
	Quarterly Fee Disclosure	Deadline for plan administrator to disclose fees and administrative expenses deducted from participant accounts during the first quarter of the plan year. Note that the quarterly fee disclosure may be included in the quarterly benefit statement or as a stand-alone document.	
May 15  (the 15 <sup>th</sup> day of the 5 <sup>th</sup> month after the end of the plan year)	IRS Forms 990 and 990-EZ	Deadline for tax-exempt trusts associated with Qualified Retirement Plans and voluntary employee beneficiary associations (VEBAs) to file Forms 990 or 990-EZ with the IRS for prior year. A 3-month extension may be obtained by filing a Form 8868, which must be filed by this date.	Qualified Retirement Plans  Voluntary Employee Beneficiary Associations