

TAX ALERT

IRS RELEASES EXAMINATION GUIDELINES ON SUBSTANTIATION FOR 401(K) HARDSHIP DISTRIBUTIONS BY CANDACE L. QUINN

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Many 401(k) plans offer participants the opportunity to withdraw monies on account of hardship. Hardship is one of the exceptions to the requirement that a 401(k) plan be established for retirement and that funds in a 401(k) normally not be distributed until the employee separates from service or attains the retirement age under the plan. Early distributions from a 401(k) plan create a risk that the plan could lose its tax-exempt qualification and subject the plan assets to taxation.

The IRS recently published a memorandum that provides IRS Employee Plan (EP) examiners with substantiation guidelines that are to be used when determining if a 401(k) plan's hardship distributions are "deemed to be on account of an immediate and heavy financial need" under safe harbor standards set forth in Treasury Regulations.

Requires Immediate and Heavy Financial Need

A 401(k) plan may provide that an employee can request a hardship distribution of elective contributions from the plan. The distribution will be considered made on account of hardship only if it is made due to an employee's immediate and heavy financial need, and is required in order to address that need.

The immediate and heavy financial need must be for one or more of the following reasons:

1. Expenses for medical care deductible for the employee or the employee's spouse, children or dependents or primary beneficiary under the plan;
2. Costs directly related to the purchase of a principal residence;
3. Payment of tuition, related educational fees, room and board expenses for up to the next 12 months of post-secondary education for the employee or the employee's spouse, children or dependents or primary beneficiary under the plan;
4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure of the mortgage on that residence;
5. Payments for burial or funeral expenses for the employee's deceased parents, spouse, children or dependents or primary beneficiary under the plan; or
6. Expenses for the repair of damages to the employee's principal residence that would qualify for the casualty deduction.

IRS Administrative Guidelines

The IRS provides a two-step process for the personnel reviewing the administration of an employer's 401(k) plan to determine if the hardship distribution was made on account of an immediate and heavy financial need.

Step 1. (i) Determine whether the employer or third-party administrator, prior to making a distribution, obtains: (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. (ii) If a summary of information on source documents is used, determine whether the employer or third-party administrator provides the employee notifications required on Attachment I prior to making a hardship distribution. (<http://ow.ly/muHI30b3pZL>)

Step 2. (i) If the employer or third-party administrator obtains source documents under Step 1(i)(a), review the documents to determine if they substantiate the hardship distribution. (ii) If the employer or third-party administrator obtains a summary of information on source documents under Step 1(i)(b), review the summary to determine whether it contains the relevant items listed on Attachment I. (iii) If the notification provided to employees in Step 1(ii) or the information reviewed in Step 2(ii) is incomplete or inconsistent on its face, the examiner may ask for source documents from the employer or third-party administrator to substantiate that a hardship distribution is deemed to be on account of an immediate and heavy financial need. (iv) If the summary of information reviewed in Step 2(ii) is complete and consistent but the examiner find employees who have received more than 2 hardship distributions in a plan year, then, in the absence of an adequate explanation for the multiple distributions and with managerial approval, the examiner may ask for source documents from the employer or third-party administrator to substantiate the distributions. Examples of an adequate explanation include follow-up medical or funeral expenses or tuition on a quarterly school calendar. (v) If a third-party administrator obtains a summary of information contained in source documents under Step 1(i)(b), determine whether the third-party administrator provides a report or other access to data to the employer, at least annually, describing the hardship distributions made during the plan year

If the above steps are satisfied, the 401(k) plan should be treated as meeting the substantiation requirements for allowing a hardship distribution deemed to be on account of an immediate and heavy financial need. Failure of an employer to satisfy the requirements could result in a proposed assessment during an IRS examination due to violation of the tax qualification requirements and potentially disqualification of the plan and loss of tax exempt status.



Mitigating Hardship Distribution Mistakes

Plan Sponsors which are seeking to mitigate hardship distribution mistakes should:

1. Review the plan document to determine when hardship distributions are allowed;
2. Review the distribution and the documentation provided by the employee to determine the basis for the hardship distribution, whether it complies with the terms of the plan and if there is certification of the unavailability of other sources of funds, and
3. Determine if the hardship distributions satisfies the IRS guidelines for substantiation.

IRS Correction Program(s)

If a mistake is found with respect to hardship distributions, the employer can use the correction programs described in Revenue Procedure 2006-27. If the plan is not the subject of an IRS examination, the plan will generally be able to correct the mistake using either the Self-Correction Program (SCP) or the Voluntary Correction Program (VCP). However, if the plan is under an IRS examination, a hardship distribution violation would have to be corrected under a closing agreement pursuant to the Audit Closing Agreement Program (Audit CAP).

Please contact your Mazars USA professional for additional information.

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