

## Employee Benefits Plan Newsletter

# Guidelines for Substantiating Hardship Distributions from a 401(k) Plan

According to current guidelines, 401(k) plans may provide that an employee can receive a distribution of his or her elective contributions due to a financial hardship arising from certain events such as medical bills, tuition payments or purchase of a principal residence.

### New Substantiation Guidelines

Specifically, by way of a memorandum to Employee Plans (EP) examination employees, the IRS has instructed its personnel to follow a process that is intended to verify that a 401(k) plan hardship distribution was processed on account of “a deemed immediate and heavy financial need.” The process that examining agents are to follow is twofold:

**Step 1:** Determine whether the plan sponsor or third-party administrator (TPA) obtained the necessary source documents (e.g., bills, estimates, contracts or other appropriate documents) prior to making a distribution, or obtained a summary (in paper, electronic format, or telephone records) of the information contained in the source documents, and, if so, determine whether the plan sponsor or TPA provided the employee with the required notifications prior to making a hardship distribution, specifically:

- 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 can be made only from the employee’s elective salary deferrals. Investment earnings from such deferrals, as well as any applicable QNEC (qualified non-elective contribution) or QMAC (qualified matching contribution) accounts, are not available to employees for purposes of a hardship withdrawal.
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the plan sponsor or administrator.

**Step 2:** If the plan sponsor or TPA obtained source documents as noted above, they must review the documents to determine if they substantiate the hardship distribution.

[The IRS memorandum](#) states that if the notification to employees or the substantiation information is incomplete or inconsistent, the examiner may ask for source documents that substantiate the need. Even if it is complete and consistent, but there are employees who have received more than two hardship distributions in a plan year, then the IRS agent, in the absence of an adequate explanation for the multiple distributions and with managerial approval, may ask for source documents from the plan sponsor or TPA to substantiate the distributions.

If a TPA obtains a summary of information contained in source documents, the examiner is told to determine whether the TPA 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 applicable requirements in Steps 1 and 2 above are satisfied, the plan should be treated as satisfying the substantiation requirement for making hardship distributions deemed to be on account of an immediate and heavy financial need.

The IRS memorandum, with attachment, can be [accessed here](#).

## **Conclusion**

Sponsors of 401(k) plans should have written procedures in place documenting how hardship distributions are approved and processed. Such procedures are necessary to ensure that plans are compliant with IRS regulations and to guard against potential plan operation failures in the event of an IRS examination.

## **Contact Us**

The Employee Benefit Services Group at PKF O'Connor Davies is available to assist employers with the implementation and/or review of hardship distribution policies, as well as provide representation during IRS examinations. We provide a full spectrum of compliance services for qualified and non-qualified employee benefit plans. For more information, please email Tim Desmond at [tdesmond@pkfod.com](mailto:tdesmond@pkfod.com) or Louis F. LiBrandi at [lbrandi@pkfod.com](mailto:lbrandi@pkfod.com) or telephone 212.286.2600.

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