
NEW ALTERNATIVE SUBSTANTIATION GUIDELINES FOR HARDSHIP WITHDRAWALS

Most 401(k) and 403(b) plans allow plan participants to take in-service hardship withdrawals. Administrators of these plans (or their recordkeepers) must obtain and preserve records substantiating a participant's request for a hardship withdrawal. The IRS recently described new alternative substantiation guidelines for its Employee Plans Examination employees to follow when they audit hardship withdrawals from a 401(k) plan or 403(b) plan.

As background, Treasury Regulations permit hardship withdrawals from 401(k) and 403(b) plans only if the hardship withdrawal (i) is made on account of an immediate and heavy financial need and (ii) is necessary to satisfy the financial need. The hardship withdrawal rules include a safe harbor for each one of these two requirements so that if the safe harbor for that requirement is met, then the requirement is deemed to be satisfied. The new substantiation guidelines are directed specifically to the safe harbor for the first requirement (*i.e.*, that the hardship withdrawal is made on account of an immediate and heavy financial need). The IRS has not relaxed its position that plan participants cannot simply self-certify their own immediate and heavy financial need.

SAFE HARBOR FOR FINANCIAL NEED REQUIREMENT

A distribution is deemed to be on account of an immediate and heavy financial need under the applicable Treasury Regulations if it is for one or more of the following:

1. Expenses for (or necessary to obtain) medical care that would be deductible under Section 213(d) of the Internal Revenue Code (Code) (determined without regard to whether the expenses exceed 7.5% of adjusted gross income);
2. Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
3. Payment of tuition, related educational fees, and 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 (as defined in Code Section 152 without regard to Code Section 152(b)(1), (b)(2) and (d)(1)(B));
4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
5. Payments for burial or funeral expenses for the employee's deceased parent, spouse, children, or dependents (as defined in Code Section 152 and without regard to Code Section 152(d)(1)(B)); or

6. Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Code Section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

SUBSTANTIATION REQUIREMENTS FOR SAFE HARBOR FOR FINANCIAL NEED REQUIREMENT

Historically, to substantiate that a participant has met the safe harbor for the immediate and heavy financial need requirement, the administrator of a 401(k) or 403(b) plan has had to obtain from the participant and preserve source documents (such as estimates, contracts, bills, and statements from third parties). As an alternative, the new substantiation guidelines allow an administrator to (i) provide to the participant the notifications described in Section I of the Attachment to this Alert, which is taken directly from an IRS Memorandum to Employee Plans Examination employees, *and* (ii) obtain from the participant and preserve the relevant summary information described in Sections II and III of the Attachment. The alternative substantiation guidelines allow for the use of paper, electronic, or telephone records.

The administrator of a 401(k) or 403(b) plan that implements the alternative substantiation guidelines will need to do so in a manner consistent with the actual hardship withdrawal provisions in the governing plan document. According to the applicable IRS Memorandum, if a participant received more than two hardship withdrawals in a plan year, then in the absence of an adequate explanation for the multiple withdrawals (such as follow-up medical or funeral expenses or tuition on a quarterly school calendar), an IRS auditor still may ask for source documents from the administrator to substantiate that participant's withdrawals. In that event, the administrator would need to call upon the participant to produce the relevant source documents in accordance with the agreement initially required of the participant by the notifications described in Section I of the Attachment.

Please contact the Thompson & Knight attorney with whom you regularly work or any of the following employee benefits attorneys to discuss this development.

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ATTACHMENT

**HARDSHIP SUBSTANTIATION INFORMATION AND
NOTIFICATIONS FOR SUMMARY OF SOURCE DOCUMENTS**

I. Notifications that the Employer/Administrator Must Provide to the Employee

- 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.
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.

II. General Information for All Hardship Requests

- Participant's name
- Total cost of the event causing hardship (for example, total cost of medical care, total cost of funeral/burial expenses, payment needed to avoid foreclosure or eviction)
- Amount of distribution requested
- Certification by the participant that the information provided is true and accurate

III. Specific Information on Deemed Hardships

A. Medical Care

- Who incurred the medical expenses (name)?
- What is the relationship to the participant (self, spouse, dependent, or primary beneficiary under the plan)?
- What was the purpose of the medical care (not the actual condition but the general category of expense; for example, diagnosis, treatment, prevention, associated transportation, long-term care)?
- Name and address of the service provider (hospital, doctor/dentist/chiropractor/other, pharmacy)
- Amount of medical expenses not covered by insurance

B. Purchase of Principal Residence

- Will this be the participant's principal residence?
- Address of the residence
- Purchase price of the principal residence

- Types of costs and expenses covered (down-payment, closing costs, and/or title fees)
- Name and address of the lender
- Date of the purchase/sale agreement
- Expected date of closing

C. Educational Payments

- Who are the educational payments for (name)?
- What is the relationship to the participant (self, spouse, child, dependent, or primary beneficiary under the plan)?
- Name and address of the educational institution
- Categories of educational payments involved (post-high school tuition, related fees, room and board)
- Period covered by the educational payments (beginning/end dates of up to 12 months)

D. Foreclosure/Eviction from Your Principal Residence

- Is this the participant's principal residence?
- Address of the residence
- Type of event (foreclosure or eviction)
- Name and address of the party that issued the foreclosure or eviction notice
- Date of the notice of foreclosure or eviction
- Due date of the payment to avoid foreclosure or eviction

E. Funeral and Burial Expenses

- Name of the deceased
- Relationship to the participant (parent, spouse, child, dependent, or primary beneficiary under the plan)
- Date of death
- Name and address of the service provider (cemetery, funeral home, etc.)

F. Repairs for Damage to Principal Residence

- Is this the participant's principal residence?
- Address of the residence that sustained damage
- Briefly describe the cause of the casualty loss (fire, flooding, type of weather-related damage, etc.), including the date of the casualty loss
- Briefly describe the repairs, including the date(s) of repair (in process or completed)