

Employee Benefits Corner

Welcomed IRS Guidance on Use of Forfeitures and Hardship Distributions

By David N. Levine and Elizabeth Thomas Dold

The IRS recently issued two pieces of long-awaited guidance to facilitate qualified plan operations. The first was the issuance of proposed regulations that would permit forfeitures to be used to fund safe harbor contributions and other corrective contributions. The second was the issuance of new audit procedures regarding the substantiation of hardship distributions, which permits a method of substantiating hardship distributions without having to review and retain the underlying support documentation to show the immediate and heavy financial need for a safe harbor hardship distribution. The new guidance is summarized below.

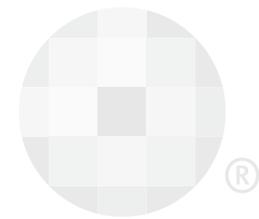
A. Expanded Use of Forfeitures

New proposed IRS regulations allow forfeitures to be used to fund corrective and safe harbor contributions to defined contribution plans that are required to be immediately 100 percent vested.¹ This is a complete reversal of the IRS's position and is welcomed relief by the benefits community.

For years, the IRS has had an informal position that a qualified matching contribution (QMAC), a qualified nonelective contribution (QNEC) and traditional safe harbor contributions (pursuant to Code Sec. 401(k)(12)) to defined contribution plans could not be funded from a plan's forfeiture account. This resulted in the employer having to fund these types of contributions from corporate assets, rather than using funds available in the plan's forfeiture account to pay for safe harbor contributions or corrective QNEC or QMAC corrections to pass coverage and nondiscrimination testing. This same concept often was also applied to correction of missed deferrals, which EPCRS (currently Rev. Proc. 2016-51) required to be made in the form of QNECs.

This limitation stemmed from the IRS's rather narrow interpretation of the regulations that required these types of contributions to be nonforfeitable. The IRS view was that the funds must be nonforfeitable when first contributed to the plan, *i.e.*, it was not sufficient that the amounts would be nonforfeitable at the time they were allocated to participants' accounts. Because forfeitures by definition were initially subject to a vesting schedule, they could never be used for these contributions.

The new proposed regulations revise the definitions of QMACs and QNECs to apply the nonforfeitable requirements when QMACs and QNECs are



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allocated to participants' accounts and not when the contributions are first made to the plan. Therefore, QNECs, QMACs and safe harbor contributions can now be funded from a plan's forfeiture account (provided that this is consistent with plan terms). This brings us to where many in the benefits community thought we should have always been.

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While this rule is effective for tax years beginning on or after the date of publication of final regulations, plan sponsors may rely on these proposed regulations for periods preceding the proposed applicability date. Moreover, to the extent the final rules are more restrictive, they will only be applied prospectively. Comments may be filed through April 18.

B. Substantiation of "Safe Harbor" Hardship Distributions

The IRS also recently modified the Internal Revenue Manual,² regarding the necessary documentation that a plan sponsor should obtain, review and retain in its records, to substantiate that a participant distribution was on account of a "safe harbor" hardship (*i.e.*, the distribution was necessary to meet an immediate and heavy financial need for plans that rely on the regulatory "safe harbor" for hardship distributions). This new exam guidance provides for two methods to meet the necessary level of documentation to support a "safe harbor" hardship distribution: (1) obtain, review and maintain "source documents" (*e.g.*, for a hardship distribution to cover medical expenses, the actual medical bills) to support a hardship distribution, or (2) obtain, review and maintain a participant's summary of the source documents without having to gather and review the source documentation. If this summary approach is taken, the participant (and not the plan) is responsible to maintain the source documents in the event of IRS audit, and there are participant and plan sponsor notification requirements that must be met.

The guidance was effective as of February 23, 2017, and includes audits open as of such date.

For some background, section 401(k) of the Internal Revenue Code ("the Code") restricts a plan's ability to

allow distributions of 401(k) deferrals and certain other amounts. Generally, such distributions are prohibited before a participant either terminates employment with the plan sponsor or reaches age 59 1/2. However, a distribution is permitted before age 59 1/2 to a participant who incurs a financial hardship. A distribution is made on account of hardship only if the distribution meets two requirements: (i) it is made on account of an immediate and heavy financial need; and (ii) it is necessary to satisfy the financial need.³ IRS regulations include rules about how to satisfy these two tests, including a safe harbor rule for each test, so that if the safe harbor is met, the requirement will be deemed to be satisfied. In short, the safe harbor for the first test provides that a distribution will be deemed to be on account of an immediate and heavy financial need if it is on account of (i) medical expenses, (ii) costs to purchase a home, (iii) tuition payments, (iv) payments to prevent eviction, (v) funeral expenses or (vi) expenses for home repair. However, IRS rules do not address the processes needed to support these determinations, which is the purpose of this new examination guideline. The level of documentation and review has historically been a concern with plan sponsors and third-party recordkeepers because if the evidence is not sufficient the distribution raises plan qualification concerns and the need to take corrective action, along with the risk of potential sanctions in an IRS audit. This is complicated by the fact that source documentation is lengthy and there is little clear guidance regarding what level of documentation is sufficient to satisfy the requirements.

Under the new guidance, there is now an option that avoids the plan sponsor and recordkeepers from having to obtain, retain and review the underlying source documentation. Instead, a plan sponsor or recordkeeper can obtain from the participant, and retain in its records, a summary of the immediate and heavy financial need information. Notably, the summary may be obtained *via* "paper, electronic format, or telephone records." The guidance also sets forth the information that must be included in the summary, which varies depending on the reason for the hardship, which is summarized below:

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

Specific Information on Deemed Hardships

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

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

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)

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

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.)

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)

There is also a requirement with this new summary approach that the employer or third-party administrator provides the employee notifications set forth below prior to making a hardship distribution:

- 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.

Lastly, the new guidance provides that if a third-party administrator obtains this summary, they must provide a report or other access to data to the employer, at least annually, describing the hardship distribution made during the plan year.⁴

This is a complete reversal of the IRS's position and is welcomed relief by the benefits community.

If, upon audit, an IRS agent reviews a summary and determines that it includes all required information, he or she can conclude that the hardship distribution was proper. However, if an IRS auditor reviews the summary and determines that it does not include the required information (*i.e.*, it is incomplete or inconsistent on its face), the auditor may request the source documents to be obtained from the participant. Notably, an auditor (with managerial approval) may also request source documents if an employee has received more than two hardship distributions in a plan year and there is not an adequate explanation for the multiple distributions (*e.g.*, adequate explanation includes follow-up medical or funeral expenses or tuition on a quarterly school calendar).

C. Action Steps

For the use of forfeitures, plan sponsors should check their plan documents to see if plan terms need to be amended to permit the use of forfeitures for these types of contribu-

We note that this hardship guidance should be equally applicable to Code Sec. 403(b) plans that utilize the safe harbor guidelines in the 401(k) regulations. Accordingly, sponsors and administrators of 403(b) plans should review their hardship processes, too.

tions. Many pre-approved plans were amended with the last PPA Restatement to include restrictive language, so we may well see pre-approved plan sponsors amending these provisions following the proposed regulations. In addition, as with any plan amendment—particularly retroactive amendments—ensure that the amendment does not raise anti-cutback concerns if forfeitures are otherwise allocated to participant accounts.

For hardship distributions, plan sponsors and service providers should review their current procedures for plans

with safe harbor hardship distributions for compliance with the new guidance, and consider whether the summary approach should be implemented (or if a version of such process has already been implemented, make any necessary revisions to clearly fall within its parameters).

Notably, the new guidance does not describe the consequences for a plan of a participant's failure to retain the source documents (or if the source documents do not support the hardship), should an IRS auditor request such documents. As explained above, the auditor should not be asking for any source documents provided that the participant notification and summary requirements are met. However, the auditor may well ask for source documentation if the auditor finds any deficiency in a summary or in the notification process. Presumably, the consequences for a plan would depend on the plan's overall compliance with the new guidance.

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ENDNOTES

¹ 82 FR 5477 (Jan. 18, 2017).

² IRM, pt. 4.72.2 (Sept. 22, 2016).

³ Reg. §1.401(k)-1(d)(3).

⁴ See www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf. (These new guidelines should replace the existing IRS website link www.irs.gov/retirement-plans/hardship-distribution-tips-from-ep-exam.)

⁵ See Reg. §1.403(b)-6(d)(2) (incorporating certain 401(k) rules).

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