Common Mistakes in the Administration of Your 401(k) or Profit Sharing Plan: Hardship Distributions

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The IRS recently issued an update to its qualified plan correction guidance, the Employee Plans Compliance Resolution System ("EPCRS") which was effective January 1, 2017.

EPCRS may be used to correct plan qualification issues affecting certain types of retirement plans, including 401(k) and profit sharing plans. It permits the correction of errors either (i) by "self-correction," whereby a plan sponsor takes reasonable steps to correct an issue, or (ii) under the auspices of the IRS via its "voluntary compliance program", whereby a plan sponsor submits a proposed correction to the IRS for review, along with a user fee, and ultimately receives a compliance statement from the IRS "blessing" the correction. For the next several issues of this newsletter, I will be reviewing the most common errors plan sponsors make and how to correct them.

Two common plan errors that we see are with regard to hardship distributions: (1) the failure to comply with the terms of the plan for hardship distributions, and (2) the failure to properly document these distributions.

Failure to Comply With the Terms of Your Plan Document. Not all plans allow hardship distributions and a primary failure is to allow these distributions when the plan document does not. There are a number of options available for hardship distributions and you must ensure that the distributions you are making comply with the provisions in your plan. Please review the terms of your plan on a periodic basis!

Documentation. Even if you use a third party administrator (TPA) to handle participant transactions, you are still ultimately responsible for the proper administration of your retirement plan. Make sure you are keeping up with the recordkeeping requirements. Plan sponsors must obtain and keep hardship distribution records. Failing to have these records available for examination is a qualification failure that should be corrected using EPCRS.

Keep these records in paper or electronic format:

1. Documentation of the hardship request, review and approval.
2. Financial information and documentation that substantiates the employee's immediate and heavy financial need.
3. Documentation to support that the hardship distribution was properly made according to applicable plan provisions and the Internal Revenue Code.
4. Proof of the actual distribution made and related Forms 1099-R.

It is insufficient for plan participants to keep their own records of hardship distributions. Participants may leave employment or fail to keep copies of hardship documentation, making their records inaccessible during an IRS audit of the plan.

Also, electronic self-certification is not sufficient documentation of the nature of a participant's hardship. IRS audits show that some TPAs allow participants to electronically self-certify that they satisfy the criteria to receive a hardship distribution. While self-certification is permitted to show that a distribution was the sole way to alleviate a hardship, self-certification is not allowed to show the nature of a hardship. You must request and retain additional documentation to show the nature of the hardship.

If you discover any discrepancies between the hardship provisions in your plan document and actual practice, or if you have not maintained complete documentation for participants' hardship distributions, please contact us so we can help you determine the best correction method.

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