



# benefits

MAGAZINE

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Recent legislation has relaxed the requirements for taking hardship distributions from defined contribution (DC) retirement plans, but some plan sponsors are hesitant to follow suit. Adopting a substantiation policy for these distributions can help minimize risks to the plan.



# Take the “Hard” Out of Hardship Distributions With a Substantiation Policy

by | **Martha Mohs**

**H**ardship distributions are a common distribution option that provides defined contribution (DC) retirement plan participants with a source of money in the event of a financial hardship.<sup>1</sup> Allowing participants to access their retirement plan account balance in the event of unforeseen medical expenses or to pay to repair damage to their home caused by a tornado is understandable. However, as Congress and the Internal Revenue Service (IRS) continue to change the substantiation requirements for these distribution options, plan sponsors are left trying to balance the desire to prevent excess leakage from a plan against wanting to avoid creating unnecessary burdens to participants experiencing a financial crisis.

This article will review the current requirements for hardship distributions and suggest guidelines for a hardship distribution policy.

### The Basics of a Hardship

*Hardship distributions* are an in-service distribution option that allows participants to request their employee and employer contributions to a DC retirement plan, including earnings, in the event of a financial hardship without a distributable event, such as death, disability or retirement.<sup>2</sup> The hardship distribution must be made on account of an “immediate and heavy financial need,” and the amount requested must be limited to the amount necessary to satisfy the financial need.<sup>3</sup>

#### **Safe Harbor Circumstances**

The Treasury identified the following circumstances as creating an immediate and heavy financial need.

- Medical expenses for the participant or the participant’s spouse, children, dependents or primary beneficiaries
- Costs directly related to the purchase of a principal residence of the participant (excluding mortgage payments)
- Tuition and related educational fees and room and board expenses for up to the next 12 months of post-secondary education expenses for the participant or the participant’s spouse, children, dependents or primary beneficiaries
- Payments necessary to prevent eviction of the participant from or foreclosure on their principal residence
- Burial and funeral expenses for the participant’s deceased parent, spouse, child, dependent or primary beneficiary

### Hardship Distributions on the Rise

The International Foundation’s 2024 *Employee Benefits Survey* found that more than three-quarters (76.2%) of respondents allow hardship distributions from their 401(k) plans and 11.8% allowed them from 403(b) plans. Corporate respondents to the survey said utilization of hardship provisions averaged 5.6% of participants for 401(k) plans, 4.9% for Roth 401(k) plans and 2.3% for 403(b) plans.



Participant use of hardship distributions is also growing, according to other research. The Vanguard *How America Saves 2024* report showed that 3.6% of participants used hardship withdrawals when offered, up from 2.8% in 2022 and 2.3% in 2019.

The Vanguard report showed that in 2023, 39% of hardship withdrawals were to avoid foreclosure or eviction, 32% were for medical expenses, 12% were for the purchase/repair of a primary residence and 14% were for tuition expenses.

- Expenses for the repair of damage to the participant’s principal residence that would qualify for a casualty deduction (e.g., property damage done by a tornado or hurricane)
- Expenses and losses (including loss of income) incurred by the participant on account of a federally declared disaster, provided that the participant’s principal residence or principal place of employment was in a designated disaster area<sup>4</sup>

#### **Facts and Circumstances Test**

In addition to the safe harbor circumstances, a plan sponsor may also determine whether a participant has an immediate and heavy financial need based on the relevant facts and circumstances.<sup>5</sup> The IRS provides an illustration of this test, noting that payment of funeral expenses constitutes a hardship, but the purchase of a boat or a television does not.<sup>6</sup> While this illustration is black and white, a determination of whether a hardship exists is typically much more nuanced.

## Who Needs Substantiation?

Historically, the IRS required plan sponsors to collect documentation substantiating the existence of the hardship circumstance and the amount required to satisfy or eliminate the financial need. In recent years, however, both Congress and the IRS have slowly eroded these substantiation requirements, instead allowing participants to self-certify their financial needs.

In 2017, the IRS issued a memorandum for employee plan examinations that created an alternate two-step method of substantiation.<sup>7</sup> Under this approach, a participant could provide a plan sponsor with a summary of the hardship event and certify the information as true and accurate. The participant was required to maintain any evidence substantiating the hardship and provide it to the plan in the event of a plan audit. Few plan sponsors elected to incorporate this change into their hardship distribution review procedures to avoid relying on participants to maintain substantiating documentation.

The winds of change once again began to blow following the passage of the Bipartisan Budget Act of 2018 and the Tax Cuts and Jobs Act, both of which impacted hardship distribution provisions. In 2018, the IRS issued additional guidance requiring participants to represent, in writing, that they have “insufficient cash or other liquid assets reasonably available to satisfy the need.”<sup>8</sup> The agency also noted that a participant may still experience an immediate and heavy financial need if the participant has assets available but “those assets are earmarked for payment of an obligation in the near future (for example, rent).”<sup>9</sup> This change effectively eliminated a plan sponsor’s obligation to confirm whether

a participant could satisfy the financial need using an alternate funding source. Instead participants were allowed to earmark any savings or other sources for alternate purposes (e.g., rent or other regular expenses) rather than use them to satisfy the hardship distribution circumstance.

In Section 312 of the SECURE 2.0 Act of 2022, Congress eliminated the substantiation requirement for hardship distributions. Instead, plan sponsors are permitted to rely on a participant’s self-certification of the existence and amount of the participant’s underlying financial need necessitating a hardship distribution unless the plan sponsor has actual knowledge to the contrary.<sup>10</sup>

However, plan sponsors have been understandably hesitant to transition to self-certification for hardship distributions. The purpose of retirement plans is to generate retirement savings. Allowing participants to self-certify hardship distributions may create a risk

that they begin to treat their accounts as a savings account rather than a retirement savings account. This creates an administrative burden due to an increase in distribution requests and also causes unnecessary plan leakage.

In addition, SECURE 2.0 does not relieve a plan sponsor of the responsibility to require substantiation or investigate the circumstances of a hardship if the plan sponsor is aware of facts that may indicate a hardship does not actually exist. This puts plan sponsors and plan administrators in a difficult position of determining whether and how to investigate hardship distributions when questions arise.

In short, while current law allows plans to permit participants to self-certify a hardship, plan sponsors and administrators cannot ignore any evidence that a hardship does not exist.

## Hardship Distribution Policies

Plan sponsors that have elected to continue requiring substantiating doc-

## takeaways

- A *hardship distribution* is an in-service distribution option that allows participants to request their employee and employer contributions to a defined contribution (DC) retirement plan, including earnings, in the event of a financial hardship without a distributable event.
- The hardship distribution must be made on account of an “immediate and heavy financial need,” and the amount requested must be limited to the amount necessary to satisfy the financial need.
- Current law allows plan participants to self-certify their financial needs, but plan sponsors are not relieved of the responsibility to require substantiation or investigate the circumstances of a hardship if the plan sponsor is aware of facts that may indicate a hardship does not actually exist.
- Plan sponsors that have elected to continue requiring substantiating documentation should consider adopting a hardship distribution policy detailing the documents required as well as the review processes and timeline for distributions.
- When considering more unusual hardship distribution requests, plan sponsors should review the request against the language of the plan document and the plan’s procedures to make a reasonable determination of eligibility.

umentation should consider adopting a hardship distribution policy detailing the documents required as well as the review processes and timeline for distributions. The IRS requires that a determination of whether a participant is experiencing an immediate and heavy financial need must be made in accordance with nondiscriminatory or objective standards.<sup>11</sup> In addition, unless the plan sponsor has actual knowledge to the contrary, it should rely on any substantiating documentation received. Accordingly, to avoid claims of discrimination, plan sponsors should establish objective criteria for review and consideration of a hardship, including standard requests of substantiating documentation.

In preparing such a policy, plan sponsors should consider the following.

#### ***Eligible Hardship Distribution Expenses***

A hardship distribution policy should provide detail regarding the specific expenses that a participant could incur that create a hardship circumstance. If a plan allows hardship distributions for the purchase of a principal residence, the policy should be clear about whether expenses incurred related to inspections, appraisal, title transfers or other fees connected to the purchase may be included in the hardship distribution request. However, the policy should also address what (if any) expenses related to the purchase of a residence do *not* constitute a hardship, such as mortgage payments, property taxes, homeowners' insurance and moving expenses.

Another question to consider is whether the initial payment of the hardship must be outstanding. In an informal

question-and-answer session moderated by the American Bar Association, the IRS indicated that medical expenses paid with a credit card could still constitute a hardship if all other factors are satisfied.<sup>12</sup> Plan sponsors could consider whether to accept credit card statements or invoices from collection agencies to substantiate the existence of a hardship.

#### ***Documentation Necessary to Demonstrate the Immediate and Heavy Financial Need***

The policy should clarify what documents the plan sponsor must receive before determining eligibility for a hardship distribution. The policy should be clear about whether the plan sponsor requires original documents or will accept copies, whether invoices must be itemized, and whether documentation can be submitted by the participant or must be submitted by the specific vendor. Plan sponsors should also consider when documentation becomes stale. For example, is the plan sponsor willing to determine eligibility for a hardship based on medical expenses detailed on an invoice dated six months ago, or should participants be required to submit current invoices?

#### ***Proximity of the Request to the Event Generating the Hardship***

Under some circumstances, a participant may wait to request a hardship distribution for some time after the event occurred. For example, if the participant has experienced a casualty loss or was impacted by a federal disaster, the participant may wait to determine what, if any, insurance payments they will receive before requesting a hardship distribution. The plan sponsor should consider whether a request for

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a hardship distribution must be made within a specific period following the event creating the hardship.

As noted above, if participants submit documentation consistent with the terms of the policy, plan sponsors should not request additional information or continue to investigate the hardship circumstance unless the plan sponsor has actual knowledge of fraud or misrepresentation.

### Consideration of Outside-the-Box Requests

Of course, no policy or set of procedures can contemplate all scenarios, and plans are nearly guaranteed to receive hardship distribution requests that do not cleanly satisfy the hardship distribution circumstances. For example, participants seeking a hardship distribution for the purchase of a principal residence might submit documentation including rent-to-own agreements or an agreement with a contractor to build the home. They might also seek reimbursement for the purchase of materials to build a residence themselves. Other unusual real-life examples include participants seeking to buy a recreational vehicle to use as a residence or the purchase of shipping containers to build a "tiny home." Some have sought to purchase a residence outside of their current state or country.

When considering hardship distributions that do not fit seamlessly into a specific hardship distribution circumstance, the plan sponsor should review the request against the language of the plan document and the plan's procedures to make a reasonable determination of eligibility. Continuing with the example of purchasing a home, the IRS finds the determination of a participant's principal residence to be based on a facts and circumstances test, including where the individual votes, receives mail, works and spends most of their time as well as the address on their driver's license.<sup>13</sup> The guidance does not require the dwelling to be permanent or a standalone dwelling. Accordingly, a houseboat or a recreational vehicle could constitute a principal residence and the purchase of such could constitute a hardship circumstance.

Plan sponsors must also consider what documentation to request participants to submit to properly substantiate unusual requests. The documentation request should be consistent with the documents requested for other hardship distribution circumstances of the same nature. For example, when reviewing a hardship distribution for the construction of a principal residence, it would seem reasonable to request an offer to purchase for the purchase of the land, documentation related to a construction loan, blueprints or building plans, building permits (if available) or other documentation that would indicate that construction of the residence is imminent. However, it would not be appropriate to approve a hardship distribution for the purchase of land if the participant does not intend to construct a residence on the property for several years.

## Conclusion

Historically, many plan sponsors reviewed hardship applications on an ad hoc basis. However, given the relaxation of substantiation rules, plan sponsors that do not allow self-certification for hardship distributions should consider adopting and following a policy for review of substantiating

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documents for hardship distributions. Without such a policy, it can be difficult for plan administrators to determine how much investigation to perform when reviewing any individual hardship distribution. Scrutinizing some applications while easily approving others could lead to claims of discrimination against a plan. However, reviewing hardship distribution applications without a critical eye could lead to plan leakage. A hardship distribution substantiation policy could help plan administrators strike an important balance. 🗨️

## Endnotes

1. While this article addresses hardship distribution provisions and administration under Internal Revenue Code (IRC) Section 401(a) plans, hardship distributions are also available under Code Section 403(b) plans and are subject to similar requirements.
2. IRC Section 401(k)(14); 26 CFR 1.401(k)-1(d)(3).
3. IRC Section 401(k)(114)(C); 26 CFR 1.401(k)-1(d)(3)(ii).
4. 26 CFR 1.401(k)-1(d)(3)(ii)(B).
5. 26 CFR 1.401(k)-1(d)(3)(ii)(A).
6. Id.
7. Internal Revenue Service Internal Memorandum for Employee Plans (EP) Examinations Employees "Substantiation Guidelines for Safe-Harbor Hardship Distributions from Section 401(k) Plans," February 23, 2017.
8. The final regulations are available at 84 Fed. Reg. 49651.
9. Preamble to final regulations available at 84 Fed. Reg. 49651.
10. IRC Section 401(k)(14)(a)(C).
11. 26 CFR 1.401(k)-1(d)(3)(i).
12. American Bar Association Section of Taxation May Meeting 2011, Joint Committee on Employee Benefits, May 5-7, 2011.
13. *IRS Publication 523*, "Selling Your Home" (2024).



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