

IRS Will Now Permit DC Plan Hardship Withdrawal Self-Certification Summaries

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Two recently published memoranda by the Internal Revenue Service (the IRS) indicate that it is permissible for 401(k) and 403(b) plan sponsors and their third party administrators (TPAs) to rely on participants' written summaries describing their financial hardships when processing hardship withdrawals from plans that apply the safe harbor event rules. Plan sponsors and TPAs may find relief from the former time-consuming, manual reviews of participants' hardship withdrawal documentation.

In Depth

The Internal Revenue Service (the IRS) recently published two memoranda to IRS examinations employees indicating that it is permissible for 401(k) and 403(b) plan sponsors and their third party administrators (TPAs) to rely on participants' written summaries describing their financial hardships when processing hardship withdrawals from plans that apply the safe harbor event rules. To use this method, the plan sponsor or TPA must confirm that the participant has provided all of the summary information described in the memoranda before approving the hardship distribution, and must provide the participant with a notification containing certain information about the distribution. These IRS memoranda provide welcome relief to plan sponsors and TPAs who have complained for years about time-consuming, manual reviews of participants' hardship withdrawal documentation.

Background

Under IRS regulations, defined contribution plans may permit a participant to withdraw retirement plan funds while actively employed if the participant experiences a financial hardship (defined as an immediate and heavy financial need) and the distribution is necessary to satisfy the financial need. The regulations allow plans to either (1) establish their own criteria for what constitutes an immediate and heavy financial need (often referred to as the "general" or "non-safe harbor" hardship withdrawal events); or (2) allow hardship withdrawals only for certain events specified in the regulations, which are deemed to automatically satisfy the requirements of immediate and heavy financial need (referred to as the "safe harbor" hardship withdrawal events). The safe harbor hardship events are as follows:

- Medical care expenses for the employee, the employee's spouse, dependents or beneficiary;

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- Costs directly related to the purchase of an employee's principal residence (excluding mortgage payments);
 - Tuition, related educational fees and room and board expenses for the next 12 months of post-secondary education for the employee or the employee's spouse, children, dependents or beneficiary;
 - Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
 - Funeral expenses for the employee, the employee's spouse, children, dependents, or beneficiary; and
 - Certain expenses to repair damage to the employee's principal residence.

Regardless of whether a plan applies the safe harbor event rules, the regulations do not outline the process plan sponsors must follow to verify that an immediate and heavy financial need has actually arisen. This lack of guidance has led to a range of approaches for substantiating the existence and extent of financial hardships. Some plan sponsors and TPAs had interpreted the existing guidance to permit reliance upon participant representations regarding the financial hardship ("self-certification"). Other sponsors and TPAs required participants to submit financial and/or legal documentation (such as copies of tuition statements, eviction or foreclosure notices), and then manually reviewed the documentation in order to substantiate the existence and extent of the financial need.

In April 2015, the IRS published an employee plans newsletter article stating that electronic self-certification was not sufficient to document the nature of a participant's financial hardship. The IRS was concerned that plan sponsors and TPAs were relying on participant representations regarding eligibility for hardship distributions without any verification, which was of particular concern in the electronic context where, in many cases, the process had become largely automated. This newsletter created more uncertainty in the benefits community as to what steps were required to substantiate hardship distributions. Those plan sponsors and TPAs that had followed the self-certification approach were concerned that the IRS expected them to obtain, review and retain detailed financial and legal records regarding participants' financial hardships, thereby adding cost and delay to the processing of hardship distribution requests.

February 27, 2017 and March 7, 2017 Memoranda

On February 27, 2017, and March 7, 2017, the IRS issued memoranda (pertaining to 401(k) plans and 403(b) plans, respectively) to IRS examiners stating that sponsors and TPAs of 401(k) and 403(b) plans that apply the safe harbor event rules can rely on a participant-provided summary of the financial hardship, provided that the summary contains certain information. This summary may be in the form of a paper document, electronic communication or telephone record. In addition, the plan sponsor or TPA must provide the participant requesting the distribution with a notification containing certain information about the distribution, as described below.

Summary Information

For a summary to be sufficient to demonstrate a financial hardship, the summary must include the following information

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- The participant's name;
 - The total cost of the event causing the hardship;
 - The amount of distribution requested;
 - Certification by the participant that the information provided is true and accurate; and
 - Certain additional information set forth in the memoranda, based on the type of hardship event (such as the address and purchase price of a principal residence, or the name and address of a medical service provider).

In addition, if a participant requests more than two hardship distributions in a plan year, the participant must provide an adequate explanation for why he or she has requested multiple distributions. The memoranda provide two examples of circumstances that would be sufficient to explain multiple hardship distributions, including follow-up medical or funeral expenses or tuition on a quarterly school calendar.

If a plan sponsor is audited and the IRS examiner determines that a summary does not provide the required information, or an adequate explanation is not provided for multiple distribution requests, the examiner may request the underlying source documents to verify that a hardship distribution was proper. The memoranda indicate that the participant is required to retain the underlying source documents and must provide them to the plan sponsor or TPA upon request.

Finally, if a plan sponsor has outsourced hardship distribution processing to a TPA and the TPA relies on a participant summary to substantiate a hardship, the TPA must provide the plan sponsor, at least once a year, with a report describing the hardship distributions made during the plan year or with access to the summary information.

Participant Notification

If a participant summary is used to substantiate a hardship, the plan sponsor or TPA is required to notify the participant that:

- 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 qualified non-elective contribution (QNEC) or qualified matching contribution (QMAC) accounts, if applicable; and
- The recipient must preserve source documents and make them available at any time, upon request, to the plan sponsor or TPA.

Next Steps

While the memoranda are not legal guidance that can be relied upon, they provide plan sponsors and

TPAs with some comfort that they can substantiate safe harbor hardship distributions without obtaining, reviewing and storing detailed participant legal and financial records, provided that they obtain a summary of the hardship that includes the required information and they provide the participant with the required notification. Plan sponsors should review their hardship distribution procedures and, if applicable, consult with their TPAs to confirm that hardship distributions are processed in accordance with this guidance. In addition, plan sponsors whose plans permit hardship distributions for non-safe harbor events may want to consider whether to limit hardship distributions to safe harbor events in the future to take advantage of the ability to substantiate a hardship event based on a summary of the hardship rather than a detailed review of participant legal and financial records.

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