



November 30, 2016

By Email

Kyle Brown  
Division Counsel  
Tax Exempt & Government Entities  
Internal Revenue Service

Re: Submission under Revenue Procedure 2016-19 – Hardship Substantiation

Dear Kyle:

We are pleased to submit this letter under the Industry Issue Resolution Program (IIRP), Revenue Procedure 2016-19, 2016-13 I.R.B. 497, in advance of our meeting on December 7, 2016. The purpose of our request is to ask the Internal Revenue Service (Service) to resolve an issue affecting a large number of taxpayers: the procedures that a defined contribution plan should use before approving a distribution upon financial hardship under Internal Revenue Code (Code) sections 401(k)(2)(B)(i)(IV), 403(b)(7), 403(b)(11)(B), Treasury Regulation section 1.401(k)-1(d)(3)(iii)(B), and similar provisions. This issue meets the requirements of Rev. Proc. 2016-19 because it is a frequently disputed and burdensome tax issue that is common to a significant number of entities and potentially affects tens of millions of plan participants.

The submission is made on behalf of the SPARK Institute, the American Benefits Council, and the Investment Company Institute. We want to thank you again for placing this issue on the Priority Guidance Plan and for meeting with us to discuss it.

As you probably know, or would reasonably expect, in the absence of any official published guidance, plan administrators and service providers have developed a variety of approaches to ensure that distributions made upon hardship are substantiated. Some plans and providers use an expensive and time-consuming procedure that makes it difficult to move to a fully electronic process. This involves requiring participants to produce a variety of paper documents justifying the hardship, which are then manually reviewed for specific information, depending on the type of hardship. This practice significantly lengthens and complicates the processing of legitimate hardship distributions for participants in distressing circumstances. For example, participants frequently submit incomplete or incorrectly completed documentation, which requires repeated phone calls or follow-up correspondence to resolve. In other cases, participants in unfortunate circumstances that qualify for hardship distributions send an

overabundance of materials that plan administrators and their delegates must sort through to identify the appropriate documentation. This approach delays processing of hardship distributions and could ultimately extend the financial hardship for the participant. Such a manual and time-intensive process is neither mandated by the Code nor necessary to ensure that participants receive a hardship distribution only when the requirements of the plan and Code are met.

The Service has recently been asserting without formal authority, in plan audits and in non-binding informal statements in IRS newsletters, that this procedure is required, which is inconsistent with prior information provided by the IRS on its website and in public forums. This inconsistency has led to substantial confusion among plan administrators and their service providers and the need for an IIRP between the Service and the retirement plan industry. As you requested, attached to this letter are additional options that we recommend the Service consider to resolve this issue. We respectfully suggest that any IRS guidance or directions that result from this process recognize that such administrative processes provide reasonable substantiation of hardship distributions.

### **Procedural Requirements of Revenue Procedure 2016-19**

**Need for Guidance:** See above. This issue is proper for resolution under Section 3.01 because it involves the following: the proper tax treatment of a common factual situation (request for hardship distributions) has been made uncertain by informal statements in various Employee Plans newsletters and the Service’s position on audit; this uncertainty results in frequent, and often repetitive, examinations of hardship distribution procedures upon audit; the issue is significant and impacts a large number of entities (see below for data); and collaboration would facilitate proper resolution of the tax issues by promoting an understanding of entities’ views and business practices. The issue is not excluded under Section 3.03 of Rev. Proc. 3.03.

**Recommendation for Resolution:** See attached.

**Requesting Groups:** This submission is made on behalf of the SPARK Institute, the American Benefits Council, and the Investment Company Institute (the Requesters), who represent “a significant number and cross section of the entities with the particular tax issue or issues.”

**Estimate of Affected Entities.** According to Department of Labor data,<sup>1</sup> there are over 534,000 plans that are listed as “401(k) type” plans, and another 21,000 listed as “403(b) plans.” In our experience, the vast majority of 401(k) plans allow distributions of elective deferrals and other contributions upon hardship.<sup>2</sup> The Requesters represent many of the sponsors of these plans and most of the service providers that provide administrative services to these plans, including services for certifying and substantiating hardship distributions. Although the Requesters do not

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<sup>1</sup> See Department of Labor, Abstract of 2014 Form 5500 Annual Reports.

<sup>2</sup> For example, according to Vanguard data, in 2015, 84 percent of plans that Vanguard services offer hardship distributions. See VANGUARD, HOW AMERICA SAVES 94 (2016). The results of the Service’s 401(k) Compliance Check indicate that 76 percent of plans permit hardship distributions. See IRS, SECTION 401(K) COMPLIANCE CHECK QUESTIONNAIRE, FINAL REPORT 6 (2013), [https://www.irs.gov/pub/irs-tege/401k\\_final\\_report.pdf](https://www.irs.gov/pub/irs-tege/401k_final_report.pdf).

represent individual participants, we note that these 401(k) and 403(b) plans cover more than 85 million individuals.

**Contact Information on Requesters**

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Attachment

## **Additional Options for Substantiation of Hardships**

The current Treasury Regulations do not specify the procedures that are required to verify a participant's claimed hardship event. When the regulations were issued in 2004, the Treasury Department declined to issue specific guidance on the documentation and verification requirements for hardship distributions.<sup>3</sup> In the absence of such specificity, plan administrators have developed their own procedures.

Many current plan procedures involve a plan administrator routinely accepting a certification from a participant without backup documentation. For example, we are unaware of any plan requiring substantiating documentation of a participant's age or marital status. In that case, if a participant certifies he or she is age 59 ½ or not married, the plan will be administered accordingly absent actual knowledge otherwise.

We appreciate the Service considering different options for substantiation of hardship. The options below are based on actual substantiation processes used by the federal government and plan sponsors. None of these involve "self-substantiation" because they require substantially more than a participant simply "checking a box." All of them result in plan records that reasonably demonstrate the nature of the hardship and that can be audited by the Service.

The key aspect of Options II and III, below, is that the plan administrator or service provider *collects from the participant the same information that would be reviewed from any paper documentation* regarding the hardship. Because this information is collected and stored **systematically and consistently** in the plan's records, these processes actually make it easier for the Service to review the plan's internal controls upon audit.

### **Option I: The Thrift Savings Plan Process**

The Thrift Savings Plan (TSP), which covers IRS and other federal employees, has developed a process for in-service withdrawals for financial hardship. To our knowledge, all of the options currently in use in the private sector (and suggested by us below) are *more* robust than that used by TSP.

- Form TSP-76 contains detailed instructions for determining what constitutes a hardship. It explains the four extraordinary expenses that qualify under TSP rules (negative monthly cash flow, medical expense, personal casualty loss, and legal expenses for separation or divorce).
- The form explains that the amount of the request cannot be more than the hardship and explains that to "receive a hardship withdrawal from your TSP account, your need must arise out of one or more" of the approved situations.
- The participant provides on part IV, line 17, of Form TSP-76 the amount of the hardship.

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<sup>3</sup> See 69 Fed. Reg. 78,144, 78,148 (Dec. 29, 2004) ("Some commentators asked for specific guidance on the documentation and verification requirements for a hardship distribution. The final regulations do not address this issue. However, taxpayers are reminded that section 6001 requires that they keep the records necessary to demonstrate compliance with the qualification requirements of section 401 and the rules of section 401(k) and 401(m).").

- The participant states on part IV, line 18, of Form TSP-76 which hardship circumstance applies (checking all that apply).
- On part VII of Form TSP-76, the instructions require the participant to sign, under penalty of perjury, based on the following representation, which could be a model for a certification in private plans:

“I agree to the conditions for a financial hardship withdrawal stated on this form. I certify that I have a financial hardship, as described in the instructions to this form, and that the dollar amount of this request does not exceed the actual amount of my financial hardship. In addition, I certify that if I did not complete Section II or III, I am an unmarried participant. I further certify that the information I have provided in this withdrawal request is true and complete to the best of my knowledge. Warning: Any intentional false statement in this application or willful misrepresentation concerning it is a violation of law that is punishable by a fine or imprisonment for as long as 5 years, or both (18 U.S.C. 1001).”

- A paper form must be notarized. Similarly, if the participant is a married Federal Employees Retirement System or Uniformed Services participant, the participant’s spouse must also sign the form, which must be notarized.

Similarly, TSP offers a “Financial Hardship Wizard” which allows the Form TSP-76 to be completed online.

**Option II: Maintain Internal Controls and Collect Specific Information on Documents in Participant’s Possession**

A process similar to the process used by the TSP, but with more internal controls and specificity of documentation, could be used. This process could be done by paper or online, but the effect and information collected is similar.

- The participant is given clear information about the requirements for requesting a hardship distribution. This includes the situations that qualify for hardship.
- During the application process, the participant must state the nature of the hardship with sufficient detail.
- The participant is given clear information about the *documents* that the participant must have and maintain, depending on which hardship is indicated.
  - For example, if the participant indicated that the hardship is payment of tuition, the process would require the participant to indicate that (a) he or she has a bill for tuition, related educational expenses and room and board; (b) the bill is for no more than the next 12 months; (c) the bill is for the employee, spouse, child, dependent, or primary beneficiary designated under the plan; and (d) the amount listed on the bill.
  - Similarly, if the participant indicated that the hardship is for repair to damages of the principal residence, the process would require the participant to indicate whether he or she has a bill for repairs or a written estimate of the amount of repairs. The process would also require the participant to represent that (a) the repairs are in fact for the primary residence, and (b) state the address of that primary residence. The

process could also require the participant to fill in the amount listed on the bill or estimate or the date of the bill or estimate.

- The process would require the participant to agree that he or she will maintain these records and present such documentation upon request from the plan administrator or the Internal Revenue Service.
- The process would alert the participant that false or fraudulent information could have serious consequences, including conviction for tax fraud.
- The process would require the participant to sign, attesting to the validity of the information provided and agreeing to preserve and present upon request the documentation stated in the application. If the signature occurs electronically, the signature would meet the requirements of applicable law, including the E-SIGN Act.
- A distribution would only be authorized for the amount necessary to satisfy the financial need stemming from a hardship, including any amounts necessary to pay federal, state, or local income taxes or penalties reasonably anticipated to result from the distributions.

The process would also require the plan administrator (or service provider, if this responsibility has been delegated) to follow up if the plan administrator has actual knowledge that the hardship request may have contained false information. If the plan administrator determines that the request may contain false information, the plan administrator should take further appropriate steps, including addressing any compliance failures pursuant to the Employee Plans Compliance Resolution System, Rev. Proc. 2013-12, 2013-4 I.R.B. 313, and considering additional controls with respect to that participant, such as requiring that the participant provide actual documentation before granting another hardship request.

### **Option III: Verbal, Recorded Certification**

Some participants prefer to do transactions through the service provider's call center. This option is similar to Option II, but can be accomplished through a call, which would be recorded if the IRS needs to audit a particular distribution.

- The participant is given clear information about the requirements for requesting a hardship distribution. This includes the situations that qualify for hardship.
- During the conversation, the participant is told that at the end of the call the participant will be asked to verbally certify, on a recorded line, that the information given is true and accurate.
- During the call, the participant must state the nature of the hardship with sufficient detail. The participant is given clear information about the *documents* that the participant must have and maintain, depending on which hardship is indicated.
  - For example, if the participant states that the hardship is eviction, then the participant is told that the acceptable documentation is a notice from the landlord or mortgage-holder providing eviction or foreclosure information, including the amount needed to prevent the eviction, the name of the landlord or mortgage-holder, the address of the property in question, and the total amount owed. Further, the documentation must be dated within the last three months.

- The participant would then be required to provide this information, including the name of the landlord or mortgage-holder, the address, and the total amount of the delinquency. (No more than the amount of the delinquency, plus the amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution, would be authorized as a distribution.)
  - Similarly, if the participant indicated that the hardship is medical expenses, the participant would need to provide the name and address of the provider on the bill, the date of the service, who incurred the medical service, and the amount on the bill.
  - The information provided to the phone representative is then entered into the plan's records.
- Similar to Option II, the call would end with the participant being alerted that false or fraudulent information could have serious consequences, including conviction for tax fraud, and requiring the participant to certify, on a recorded line:
    - The nature of the hardship
    - That the details were accurately provided
    - That the participant must maintain records with these details and produce such documentation upon request by the plan administrator or the IRS.

Additionally, like with Option II, this process would also require the plan administrator to follow up if the plan administrator has actual knowledge that the hardship request may have contained false information.

By collecting *the same information that would be reviewed if the actual bill were provided*, the plan is actually making it easier to audit the plan's records, because this information is now in the plan's records in a standardized format.