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The Hardship of Administering 401(k) Plan Hardship Withdrawals

The administration of hardship distributions can be one of the most significant burdens employers face in managing their 401(k) plans. Employers often choose to include hardship distribution provisions in their plan to eliminate a concern participants might otherwise have about making contributions being able to access funds when in dire need makes participants more confident about saving. The disadvantage of such a provision is that it requires an administrative process that involves delving into the messy financial lives of employees, something most employers prefer to avoid.

Many employers contract with a third-party administrator or platform vendor to administer the hardship application and approval process. But, even if outsourced, employers are the ones at risk of tax liabilities or plan disqualification if the process is not consistent with the very limited authority for early distributions on account of hardship contained in the Code and related regulations. The IRS has made clear that the reasons for and amount requested in a hardship withdrawal must be substantiated with supporting documents in order for a hardship withdrawal to be consistent with the Code's rules. Until recently, the IRS's position was that the employer or its administrative vendor must review and retain those substantiation documents to prove compliance in the event of an audit. In February, 2017, the IRS indicated a softening of its views on the hardship paperwork burden; employers may now want to reconsider how they or their vendors process hardships as a result.

The IRS Softens its Position on Hardship Substantiation

In the April 2015 issue of *Employee Plans News*, the IRS put employers on notice that a process adopted by some national retirement plan administrative vendors to streamline hardship applications created a qualification failure. A hardship process that allows employees to self-certify that they need a requested

withdrawal for a statutory hardship reason, and does not also involve the employer or vendor getting and reviewing supporting documentation (such as a foreclosure notice, medical bills, etc.), does not meet statutory requirements, according to the IRS news release. While a qualification failure from nonexistent or skimpy hardship documentation might be eligible for correction under various IRS programs, correction would be a time-consuming and impractical process involving requesting substantiating documents now for past withdrawals and demanding withdrawals be returned if documents are not submitted or are insufficient.

In February, 2017, the IRS issued [a new directive](#) to Employee Plans Examiners that appears to allow 401(k) plans to reduce the paperwork that is exchanged and reviewed in the hardship process, but also would require a revamping of hardship notices and applications. In March 2017, a similar directive was issued to examiners of 403(b) Plans. The new examination guidelines do not change the law; they simply change what IRS auditors will ask for when looking at a plan's hardship withdrawals to determine if the plan has been operated in accordance with its terms, the Code and regulations.

The new approach does not eliminate the need for any documentation, or provide that mere self-certification of the need by the participant is allowed, but it does permit the plan sponsor an alternative method for documenting the need for the distribution. The plan sponsor may either:

- (1) continue processing hardships the "old" way: request the actual source documents that substantiate the need for the distribution and verify that they support the reason given, or
- (2) provide participants with a notice and ask that they (a) answer specific questions in the application that serve to summarize the information that would be contained in the substantiating source documents, and (b) agree to retain the supporting documents and produce them at any time upon request.

The notice that must be provided to participants under method (2) must give general background on the limits regarding hardships and

on the facts that must exist to qualify, as well as information on the tax consequences of a hardship withdrawal. The application that participants must complete has to request some very specific information, much of which varies based on the reason for the hardship. For example, if the request is for medical expenses, the application must ask:

- Who incurred the medical expense (name)?
- What is the relationship of that person to the participant (self, spouse, dependents 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 the medical expenses not covered by insurance.

The IRS included an attachment to its guidance that lists the information that an IRS agent would seek “depending on the reason stated for the hardship” when reviewing a plan sponsor’s documentation to see if the need for a hardship distribution was substantiated. However, auditors are still instructed to ask an employer or vendor to produce the underlying documents that support the reason for the “immediate and heavy financial need,” if there are any notice gaps or irregularities in what participants certify when applying for a hardship. That would mean that an employer then has to ask the participant for those records, and nothing in the examination guidelines indicates what the consequence might be if the participant is unresponsive or produces records that are not supportive of what they stated in their application.

Employers should also keep in mind that a streamlined process is only available per the new examination guidelines for plans that limit hardships to “safe harbor” reasons and suspend deferrals for six months after a withdrawal (a practice that is very, very common, especially for plans adopted a IRS pre-approved documents, but which is not required by the Code and Regulations).

Next Steps

Many plan sponsors will be excited to embark on a less-intrusive, paperless process for hardship withdrawals. Requesting summary information instead of obtaining actual copies of source documents to substantiate a hardship distribution is appealing on its face. But plan sponsors should proceed carefully to ensure that they (or their vendors) closely follow the requirements of the new guidance, and consider whether they feel comfortable relying on participants to fulfill their responsibility to retain their source documents, or are willing to risk whatever the consequence might be if an auditor ever demands to see supporting documents that are not produced.

Be Alert for Hardship Fraud

Employers might also want to consider a focused annual review of hardship behavior to be alert for the possibility that the process has become so easy that participants no longer take seriously the protection of their retirement savings. Fraud is not uncommon with current, more intrusive, hardship application processes. For example, employers have found the same home purchased by five different employees in one city within a period of few months, using the same supporting paperwork “doctored” to add a different name. One participant with multiple withdrawals in a short time is an easy “red flag,” but other patterns that imply fraud are pretty easy to detect when a review is conducted, and those patterns indicate a need to tighten processes and cross-checks to preserve your plan’s tax qualified status and protect your employees from financial predators.

For more information, please contact [Debbie Reiss Hardesty](#) or any other attorney in Frost Brown Todd’s [Employee Benefits](#) group.

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