



The Regulatory Pendulum Swings

**What the Biden
Administration
Will Mean for
Delaware's Banks**

Accounting for Success



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Why Should Taking a Hardship Distribution be a Hardship?

Taking a hardship distribution should not be, in itself, a hardship to a participant going through challenging times, nor should it be an administration hardship to the employer trying to help. Although obtaining documentation to substantiate a hardship is not, in itself, difficult, missing hardship backup is one of the most common operational errors we find during financial statement audits. The reason is that every party involved thinks someone else is responsible for obtaining the backup, so nobody does it. To make matters worse, some large recordkeepers had erroneously taken the position that self-certification from participants was permissible, both by stating that there was no other financing available to meet the need and also for the hardship reason and amount.

Do More Options Make It Simpler?

Now, both alternatives are options:

- backup documentation for the hardship reason and amount can still be required, or
- the participant can self-certify the hardship reason, amount, and financial necessity, in writing, including a statement that the information provided is truthful and accurate. If self-certification is used, the employer must provide written notification of the taxability of the distribution, the rules regarding the definition of hardship and limitations, and the requirement that the participant maintain the backup.

Self-certification facilitates automation of the hardship approval by the recordkeeper; however, electronic approval of hardship distribution requests through the plan webstation is not always the default. Thus, we continue to find instances in which neither backup nor compliant self-certifications were obtained for hardship distributions. Unfortunately, self-certification does not mean that an email or a phone call from the participant is sufficient.

Safe Harbor Definition of Hardship

The issuance of ineligible hardship distributions is another common error we find during our audits. Sympathetic employers tend to forget that the plan cannot be changed to reflect their wishes regarding available hardships without a written amendment. In this case, when you wish upon a star, it makes no difference who you are. The employer cannot change the reasons for which hardships are granted without a plan amendment and doing so could affect the qualified status of the plan. Most pre-approved plans default to the

Treasury Regulations' safe harbor definition of a hardship. Those regulations provide for a "safe harbor" listing of events, all of which are deemed to meet the Internal Revenue Code's requirements for hardship distributions, which makes the process of determining qualification for a hardship distribution easier for the plan administrator. As a result, most plans limit the qualifying events for a hardship distribution to this list:

- Medical expenses for the participant, spouse, children, dependents, or his or her primary beneficiary, if they would be deductible under Code section 213(d), disregarding the requirement that they exceed 10% of adjusted gross income;
- Costs relating to the purchase of the participant's principal residence (excluding mortgage payments);
- Tuition and related educational fees and room and board expenses for up to the next 12 months of post-secondary education for the participant or his or her spouse, children, dependents, or designated beneficiary;
- Payments necessary to prevent the participant's eviction from, or foreclosure on, his or her principal residence;
- Burial or funeral expenses for the participant's deceased parent, spouse, child, dependent, or primary beneficiary;
- Expenses for the repair of damage to the participant's principal residence that would qualify for the casualty deduction under Internal Revenue Code section 165, disregarding the requirement that the damage was caused by a federally declared disaster; and
- Expenses and losses (including loss of income) incurred by the participant on account of a federally declared (i.e., by the Federal Emergency Management Agency (FEMA)) disaster, if the participant's principal residence or place of employment was in the area designated by FEMA for individual assistance with respect to the disaster.

If the participant's parents have medical expenses, or the participant's mortgage payments are late, but there is no eviction notice, or the participant's niece or nephew needs tuition assistance, or the participant's cat needs surgery, or any other costly and unfortunate situation strikes the participant or someone they care for, but is not a hardship reason permitted in the plan, the employer has to consult the document provider regarding the possibility for an amendment that could make it possible to assist the affected participant. Many employers don't realize that the safe harbor hardship reasons

are not the only hardship reasons permitted in a defined contribution plan.

Audit Procedures for Hardship Distributions

In September 2019, Final Regulations were published regarding hardship distributions from 401(k) plans. Although many of the rules regarding hardship distributions were relaxed, the new leniency is often optional, so the auditor will not assume that your plan adopted all the new options, such as available sources for a hardship distribution including the participant's entire 401(k) account, or that maximizing all available participant loans is no longer required. For these previously mandatory requirements to be eliminated, the plan sponsor must actively choose to implement the more lenient provisions. Conversely, 403(b) plans cannot choose to offer hardship distributions from earnings on deferrals, or from employer contributions, including QNECs, QMACs, or safe harbor contributions for custodial account/mutual fund 403(b) plans, because the Final Treasury Regulations did not change the available sources as it did for 401(k) plans. Lastly, some changes are not optional. Effective 1/1/2020, the suspension of deferrals after a hardship distribution is no longer an option. Our audits will verify that deferrals do not stop automatically after hardship distributions, unless the participant elects to stop deferral withholdings.

Mistakes Happen, but There's a Fix-It Guide for That!

Revenue Procedure 2019-19 – the most current Employee Plans Compliance Resolution System (EPCRS), offers several pre-approved self-correction opportunities for plan operations that go astray, including hardship distribution administration.

EPCRS gives plan sponsors the ability to retroactively amend the plan to match the plan provisions with the plan operations, as long as: (1) the amendment results in an increase of a benefit, right, or feature; (2) the increase applies to all employees eligible to participate in the plan; and (3) providing the increase is permitted under the other requirements of the Code and EPCRS. Nonetheless, ineligible hardship distributions are considered to be overpayments of benefits to

participants. Retroactive amendments are not permitted to self-correct overpayments — the plan sponsor must ask the participant to return the money to the plan.

If the participant returns the distribution to the plan, the failure is corrected. However, participants tend to spend dollars connected to ineligible distributions right away, and often cannot return the money. Thankfully, under EPCRS, a plan sponsor does not need to make the plan whole if the failure arose solely because payment of a participant's benefits was made in the absence of a distributable event but was otherwise determined in accordance with the terms of the plan. In this case, requesting the refund seems like it would be a sufficient correction, but we always advise plan sponsors to consult ERISA counsel if they want reassurance that they have properly corrected the operational error. If the participant has terminated employment when the failure is found, the participant would have become eligible for a distribution, and no further correction is needed.

Documentation or Self-Certification Not Obtained — Ideally, the simplest correction possible and available is for the plan sponsor to, *post facto*, get the necessary documentation from the participant, whether it is the hardship reason documentation or the self-certification, as applicable.

More Options, More Opportunity for Error, More Ways to Fix It

Adding self-certification to the hardship distribution substantiation options, made them easier to administer if the employer follows the rules, but also created more ways to get it wrong. Fortunately, the most recent EPCRS offers numerous pre-approved ways to self-correct or to request approval for significant or nonstandard corrections. Whether it comes to preventing, detecting, or correcting operational failures, we can work hand-in-hand with the employer, third-party administrator, recordkeepers, and ERISA attorneys to make everything right. For every mistake, there is always a solution.



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