
*In This Edition:*



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## Hardship Distributions: T's to Cross and I's to Dot

A qualified retirement plan, such as an IRC Section 401(k) plan or 403(b) plan, can include a hardship withdrawal provision. If a plan is to include a hardship withdrawal provision, it is subject to many restrictions.

In summary, a hardship withdrawal is available to a plan participant in the event he/she experiences an immediate and heavy financial need. The current IRS and Treasury regulations set forth the criteria for determining whether an expense constitutes an immediate and heavy financial need. For example, while paying the funeral expenses of a family member would probably meet this criteria, the purchase of a boat or a TV would not.

According to these safe harbor rules, a distribution from a qualified plan is deemed to be an immediate and heavy financial need if the distribution is for:

- Necessary medical care expenses that would be deductible under IRC Section 213(d), determined without regard to whether the expenses exceed 10 percent of adjusted gross income;
- Costs directly related to the purchase of a principal residence for the employee, excluding mortgage payments;
- Payment of tuition, related educational fees, and room and board expenses, for up to 12 months of post-secondary education for the employee, spouse, children, or qualified tax dependents;
- Payments necessary to prevent the eviction of the employee from his/her principal residence or foreclosure on the mortgage on that residence;
- Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or qualified tax dependents; or
- Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under IRC Section 165.

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Generally, a hardship distribution is treated to satisfy an immediate and heavy financial need only to the extent the amount of the distribution does not exceed the amount required to satisfy the financial need, with an option to include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

In addition, substantiation of the immediate and financial need is required. Recently, the IRS released two nearly identical Memoranda, one specific to **401(k) plans** and the other specific to **403(b) plans**; both of these are directed at internal IRS auditors who audit plans. The Memoranda sets forth modified substantiation guidelines to assist in determining whether a hardship distribution is deemed to meet the immediate and heavy financial need criteria. While this type of IRS directive does not carry the force of law, it does give plan administrators an idea on what is important to the IRS.

According to this Memoranda, there are two steps involved for making the financial burden determination:

The **first step** is to determine whether the employer or third-party administrator (TPA), prior to making a distribution, either:

1. Obtains source documents from the employee-participant such as estimates, contracts, bills and statements from third parties; or
2. Obtains only a summary of information contained in such source documents. In this instance, the employer or TPA should then notify the employee-participant requesting the distribution stating 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 employee-participant agrees to preserve the actual source documents of the expenses and make them available at any time, upon request, to the employer or TPA. This could be problematic in that at the time of an IRS audit, the individual may have terminated employment, or may have otherwise failed to retain the source documents. Thus, many plan administrators may wish to receive the actual substantiation documentation.

In the **second step,** the employer or TPA must review the information received from the employee-participant to determine whether it substantiates the hardship distribution requirements. The page labeled "Attachment 1" contained in the Memoranda provides a sampling of questions that an employer or TPA could use when seeking substantiation for a specific purpose. For example, if the request for the hardship withdrawal is to pay medical care expenses, then the employee-participant should provide documentation that:

1. Identifies the individual who incurred the medical expenses and the relationship to the employee-participant (self, spouse, dependent, or primary beneficiary under the plan);
2. Describes the purpose of the medical care; for example, diagnosis, treatment, prevention, associated transportation, long-term care;
3. Provides the name and address of the service provider(s) such as the hospital, doctor, dentist, chiropractor, pharmacy; and
4. Identifies the amount of medical expenses not covered by insurance.

It should be noted that if a plan permits more than two hardship distributions a year, additional substantiation could be required. Plans may want to limit hardship distributions to no more than two withdrawals per year.

For additional information relating to hardship distributions, the IRS provides some FAQs and tips for retirement plan sponsors:

- *Hardship Distribution Tips*
- *Retirement Plans FAQs regarding Hardship Distributions*

## Fiduciary Rule Implementation Extended

As a follow up to last month's *Benefit Beat* article, *Applicability Date of Fiduciary Advice Rules Extended*, the Department of Labor's Employee Benefit Security Administration **finalized the 60-day extension** of the applicability date of the fiduciary advice rules. These rules were to become applicable on April 10, 2017. With the 60-day extension, the fiduciary rules now become applicable and enforceable on June 9, 2017.

## A Cafeteria Plan Forfeiture Reminder

A recent Information Letter released from the Department of Treasury (**Information Letter 2016-0077**) provides a good reminder about understanding how an IRC Section 125 (cafeteria) plan, specifically a flexible medical spending account (FSA) plan, handles plan forfeitures.

The question asked in this Letter relates to whether unused funds of a former plan participant of an FSA plan are required to be relinquished to the U. S. Treasury. The answer to this question is, "no". Forfeitures in a cafeteria plan or FSA plan can only be used in the manner specifically provided for in the plan document, and cannot be returned to the participant on a dollar for dollar basis. Generally, the plan document will provide that forfeitures can be used to defray administrative costs, or to reduce future contributions, or both. Thus, it is important that the terms and conditions of the plan are followed, specifically as it relates to forfeitures of unused funds.

## San Francisco: HCSO Employer Annual Reporting Obligation and Paid Parental Leave Reminders and Resources

- **HCSO's Annual Employer Reporting Obligation**

  Employers subject to the San Francisco's Health Care Security Ordinance (HCSO) are required to annually report their health care expenditures to the Office of Labor Standards Enforcement (OLSE). Both the ***2016 Employer Annual Reporting Form*** and related **instructions** are now available on the **OLSE's website**. The deadline for submitting the Annual Reporting Form is May 1, 2017. Employers who fail to submit an annual report on time may be subject to penalties of $500 for each quarter the violation occurs.

  OLSE is hosting two webinars to assist employers in completing their 2016 Employer Annual Reporting Form on April 4th and April 12th at 10 am PST. While space is limited to 100 participants per webinar, the OLSE indicates that a recording of these webinars will be posted on OLSE's website sometime after April 12, 2017.

  As background, a business is subject to HCSO if it engages in business within the City of San Francisco and employs 20 or more employees per week. Nonprofit employers with fewer than 50 employees, and small employers with fewer than 20 employees, are exempt from the HCSO. For 2017, the applicable health care expenditure rate for large businesses employing 100+ employees is $2.64 per hour; the rate for businesses with 20-99 employees and nonprofits employing 50-99 employees is $1.76 per hour (see *San Francisco HCSO Expenditure Rates for 2017*, *Benefit Beat*, 9/12/16).

- **Paid Parental Leave Reminders and Resources**

  Last year, Mayor Lee signed the *Paid Parental Leave Ordinance* requiring most employers with employees in San Francisco to begin bridging the gap between an employee's paid family leave benefit and the employee's regular compensation. This Ordinance provides for up to 6 weeks of supplemental compensation to employees receiving paid leave benefits under California's Paid Family Leave program for purposes of newborn baby bonding. For a summary of the Ordinance, see *San Francisco's Paid Parental Leave Ordinance* (*Benefit Beat*, 5/5/16).

  As a reminder, the law is being implemented in 3 phases:
  - Employers with 50 or more employees were required to comply beginning on January 1, 2017.
  - Employers with 35 or more employees are required to comply beginning on July 1, 2017.
  - Employers with 20 or more employees are required to comply beginning on January 1, 2018.

  The OLSE provides more detailed information about the Ordinance on its website including a webinar slide deck, a step-by-step guide, the required workplace poster, the model form that can be used to request leave (in English, Spanish and Chinese), as well as an online calculator for determining amounts of supplemental compensation to be paid.

## IRS Again Warning of Phishing Scams

Thus far in 2017, the Internal Revenue Service, state tax agencies and the tax industry have released six official "Alerts" warning employers, tax professionals and tax payers of new and evolving phishing email scams.

Of particular note, a recently released **Alert** warns of a Form W-2 email phishing scam, which first appeared last year targeting corporate entities, but has now resurfaced and spreading to other sectors including school districts, tribal organizations and nonprofits. This scam involves various spoofing techniques to disguise an email to make it appear as if it is from an executive within the organization. The email is typically sent to a payroll or human resources department requesting a list of all employees and their Forms W-2. The latest twist to this scam is an additional request by the so-called executive to set up a wire transfer to a certain account. The IRS provides steps in the Alert for employers to take if they fall victim to this W-2 scam.

The IRS reports that businesses and payroll service providers can now quickly report data losses resulting from a scam where employees are tricked into revealing W-2 information. Additional information is available in this new release: ***Form W2/SSN Data Theft: Information for Businesses and Payroll Service Providers***. The IRS indicates that if notified in time, the IRS can prevent employees from being victimized by identity thieves filing fraudulent returns in their names.

Employers and tax professionals can keep track of various nefarious activities by visiting the IRS' accumulation of alerts on its website: http://www.irs.gov/individuals/protect-your-clients-protect-yourself.

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