This article is published by Ferenczy Benefits Law Center to provide information to our clients and friends about developments. It is intended to be informational and does not constitute legal advice for any particular situation. It also may be considered to be "attorney advertising" under the rules of certain states.

Flashpoint: Fiduciary Rules and 401(k) Hardship Distributions: The Latest

We are accustomed to change in this industry, but things seem to be moving quite quickly on several fronts. In this issue of the FlashPoint, we will bring you up to date as to where we stand on the Department of Labor's (DOL) fiduciary rule changes, and also clarify the IRS's new policy on hardship distribution substantiation in 401(k) plans.

The Latest Info Re the Fiduciary Regulation

Several steps have been taken by the Administration since President Trump's inauguration that will likely delay the April 10 deadline for complying with the DOL's fiduciary regulation.

On February 3, the Administration issued a Memorandum, directing the DOL to reexamine the regulation and to prepare an economic and legal analysis regarding the likely impact of the regulation if it should become effective. In particular, the President wanted to know:

- Will the regulation likely harm investors due to a reduced access to retirement savings offerings, products, information, or advice?
- Will it cause dislocations and disruptions in the retirement service industry that will affect investors?
- Will it cause an increase in litigation or prices?

If the answer to any of these questions is "yes," the Memo directs the DOL to publish a notice of intent to rescind or revise the rule, with an adequate comment period.

The original version of the Memo, which was leaked on February 2, ordered a six-month delay in the effective date of the regulation. However, this type of delay cannot be done by a Presidential action, but requires a new regulation. Therefore, the final version of the Memo did not mention any delay in the effective date.

On March 2, the DOL issued a proposed regulation, providing for the delay of the April 10 applicability date to June 9, to permit the retirement plan and investment communities to postpone having to comply with the new rules while the DOL was still doing the study the President directed.

The proposed regulation, as required, provided a 15-day comment period, which will end March 17. Assuming that the comments do not provide compelling reasons why the regulation should not be adopted, the deadline for compliance with the fiduciary regulation will be delayed until June 9. As of March 10, the DOL has published 345 comment letters that it has received.

So, Now What?

Assuming the DOL finalizes the proposed regulation after March 17, the DOL fiduciary regulation will not be applicable until, at the earliest, June 9. Therefore, everyone who has been panicking at the thought of having all compliance preparation completed within the month can take a deep breath and perhaps have a light alcoholic beverage.

Nonetheless, the delay simply extends the period during which we are all unsure about how to proceed. This period of uncertainty leaves us all wondering what the best approach is. Should a financial advisor or institution continue to put money and effort into proper compliance, so that they are not caught flat-footed on June 9 if the regulation is not further delayed or overhauled? Should we assume that the DOL (which still lacks a Secretary at the helm) will report to the President that the regulation is going to cause the numerous ills about which the Memo spoke, and belay compliance efforts? In many ways, such a report would repudiate reports issued by the DOL under the Obama Administration that documented the perceived need for this guidance.

The DOL's Latest Word

Late Friday, March 10, Mabel Capolongo, the DOL's Director of Enforcement, issued Field Assistance Bulletin (FAB) 2017-01, acknowledging the distress of practitioners that did not know what was to be expected of them over the next 60 days. The FAB states that it is the DOL's intent to decide before April 10 whether the 60-day delay in applicability will apply, but admits that there could be a gap period between April 10 and the date on which the public knows for certain that the April 10 date has been delayed. The FAB assures practitioners that it will not enforce the fiduciary regulation during that gap period, including any the rules that require certain disclosures to be provided to clients and participants.

Furthermore, the FAB notes that, even if there is no delay past the April date, the DOL will not strictly enforce the fiduciary regulation or the related prohibited transaction exemptions for a reasonable period after the applicability date. Again, this includes a failure to provide the necessary disclosures, so long as the practitioner corrects any failures within 30 days of becoming aware (or when it should have been aware) of the noncompliance.

Additional Thoughts About the Regulation

An interesting byproduct of the regulatory process over the past several years is that both advisors and plan-related clients have been sensitized to many of the issues addressed—albeit sometimes clumsily—in the fiduciary regulation. For example, should a plan require that its investment advisor act as a fiduciary, even if the regulation ends up not requiring this? If not, why would a plan want to retain someone who is not required to act in the plan's best interest?

In addition, there are several issues about which advisors have been concerned for some time that were addressed positively in the regulation. For example, the "BICE Lite" rules that permit plan fiduciaries to give advice to participants about distributions and rollovers were a huge help in ensuring that doing so was not a prohibited transaction and that all advisors—those who normally provide advice to the plan and those who are advising only participant only in this

transaction—were subject to the same rules. Similarly, sections of the BICE permitted fiduciaries to receive variable compensation, something not permitted under the existing rules.

Therefore, there is some reason for the DOL to consider not throwing out the baby with the bathwater by simply revoking the fiduciary regulation. Not unlike the process going on in regard to health care, there may be some parts of the new rules that we like and want to keep. Picking through the rules and identifying those, as well as making those parts workable without the balance of the regulation in place, may be a significant challenge to the new DOL.

Hardship Substantiation

Plans that offer their participants the ability to take a hardship distribution must follow specific rules. In particular, 401(k) plans require that the participant have sustained a heavy and immediate financial need and that the participant's resources be insufficient to satisfy the need, causing the participant to look to the funds saved in his or her 401(k) account.

Background

Historically, IRS procedures have required that the plan obtain from the participant documentation substantiating the occurrence of an event that qualifies as a hardship based on the terms of the plan and the permissible hardship rules of the Code. Although plans may interpret what events support a hardship, IRS regulations provide a "safe harbor" list of events that can be relied upon as being sufficiently critical to cause a hardship need. Those events include: the participant buying a primary residence; the participant or certain family members sustaining unreimbursed medical expenses; the participant or certain family members going to college and paying tuition, fees, and expenses; payment to prevent imminent eviction from or foreclosure on the participant's residence; payment of expenses to repair casualty losses to the participant's home; and the payment of funeral expenses for certain family members. IRS auditors have expected on audit to see paperwork, such as medical or repair bills, tuition invoices, and contracts or escrow documents in connection with a house purchase, to demonstrate the occurrence of the hardship and the amount of money that needed to be expended to resolve the problem, but often ended up citing employers who lacked this type of substantiation for deficient documentation.

Besides having demonstrated that a hardship event occurred, the participant must also show that the hardship was such that the 401(k) distribution was necessary to satisfy the financial need caused by the event. To prevent employers from being in the position of reviewing their employees' financials and judging how dire their straits are, the IRS permitted this requirement to be demonstrated through an attestation by the participant that s/he had no other assets to meet the need. Alternatively, the plan could require a termination of the participant's salary deferrals for a six-month period and that the participant take any available loans or distributions from the 401(k) plan or any other plan of the employer before resorting to a hardship distribution.

Significant confusion has reigned in the industry about these requirements, with many providers (including several very large providers) believing that the attestation discussed above could cover the demonstration of both the need and the lack of other resources to satisfy the need. This is contrary to what the regulation says, and what the IRS claims it has stated in various venues historically. Nonetheless, several providers were surprised when clients were under IRS audit that the lack of actual hardship documentation was a problem and that the participant's claim that the hardship occurred was insufficient.

The IRS Memo and the Newly Permitted Procedures

Clearly as an attempt to find common ground, the IRS's Acting Director of Employee Plans Examinations issued a memorandum to its auditors on February 23, 2017, clarifying what was acceptable hardship substantiation in an examination of a 401(k) plan (the "Memo").

Under the Memo, the IRS instructs its examiners to ask for documentation supporting the occurrence of a hardship event (what it calls "source documents"). These include the receipts or billing or other documents mentioned earlier. If this is not available, the auditor is to request that s/he be given a summary of the source documents that support the hardship.

If the source documents are provided, the auditor should review those to determine if they substantiate the hardship event.

If source documents are not provided, the IRS will examine the employer to see if certain procedures were taken in connection with receiving the summary of the source documentation. If those procedures were followed, the IRS auditor is directed to consider the matter closed. However, if the IRS reviews the summary and other information, and finds that a participant has received more than two hardship distributions in a plan year, the auditor (upon obtaining his or her manager's approval) may request that the source documents be obtained from the participant or the third party administrator to substantiate the hardship. It appears from the Memo that this is the **sole basis** upon which the IRS may look further into hardship-related compliance.

What Are the Required Procedures?

There are two aspects of the new procedures if the summary of expenses method is used. The first is one of disclosure. The employer must provide the employee who requests a hardship with information about the taxability of the hardship, the limitation on the amount and the account sources for the hardship distribution, as well as notice to the participant that s/he must retain the source documents that prove that the hardship occurred and its cost.

The second part of the procedure is that the employee must provide the summary of the hardship event and expenses, as well as additional information particular to each type of hardship. The employee must also certify that the information s/he provides is true and accurate.

What Is the Upshot of This?

Employers that currently require participants to provide actual documentation about the hardship event's occurrence and cost may continue to do this, and should be sure to retain that documentation to show in the event of an IRS audit. Furthermore, those historic hardship distributions comply with the IRS's rules—both old and new.

On the other hand, employers who are comfortable with the alternate procedure need to be sure that their disclosure and certification meet the Memo's requirements. Documents for this purpose can be put together into a handy package for use whenever a hardship situation arises.

If you need help putting this package together, please let us know. We can help!

What About Old Hardship Distributions?

The Memo makes it clear that the new procedures apply to any open audits. Unfortunately, the Memo's requirements about what must accompany the participant's certification were not known in the past. Therefore, there is still some significant risk to plans that used the certification method before the Memo was issued. Such plans may find it valuable to ask participants who took hardship distributions during years that are open to examination (the statute of limitations on IRS examinations for a given plan year commonly expires three years after the filing of the Form 5500 in relation to that year) to produce the source documentation or, at least, the summary documentation that is needed under the Memo. While doing the latter will not make the prior hardship distribution fully compliant with the new Memo, it may get the plan as close to retroactive compliance as is possible.

If you want to talk to us about historic hardship distributions, complying with the new Memo, or about any other technical issue, please call or email us.

<u>On the Lighter Side</u>

Check out our new website, at www.ferenczylaw.com. Pretty spiffy, huh? We hope that you find the information there easy to access and useful. Let us know if you have any comments to share.

Also, remember that we are looking forward to seeing you at Pensions on Peachtree, April 24 and 25. We've added a Sunday evening cocktail and artisanal cheese mixer to be held at our office, across the street from the conference hotel. Be sure to come early enough to attend!