

Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues

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Hardship Distributions Provide Valuable Option

In an ideal world, we would all contribute as much money as possible to our retirement plans and allow it to grow until we were ready to retire. We could then enjoy our twilight years with comfort and security, be it traveling the world or relaxing by the pool.

In the real world, life doesn't always go as planned. Doctor bills, college tuition and personal emergencies can arise and stress our finances to the max. During these times an employee may be relieved to know that his retirement account, though intended for retirement, is also available for financial hardship.

The type of retirement plan most likely to offer hardship distributions is the ever-popular 401(k) plan, funded primarily by employee salary deferrals. Section 403(b) and section 457(b) plans are also funded by salary deferrals and are likely to permit hardship distributions as well. However, such distributions are not limited to deferral accounts and other accounts under a profit sharing plan may provide them.

What follows is a close-up look at the rules concerning hardship distributions, including some provisions added by final regulations that many plans will incorporate this year. It also includes special provisions adopted last year to provide relief to victims of Hurricane Katrina.

Salary Deferral vs. Employer Accounts

The overwhelming majority of hardship distributions are dispensed from participants' 401(k) (salary deferral) accounts. In fact, hardship is the only allowable reason for an in-service distribution from salary deferral accounts prior to age 59½ (other than plan termination without an alternative plan).

Profit sharing plans may allow in-service distributions of employer-funded benefits (e.g., match or profit sharing contributions) prior to age 59½, conditioned upon the occurrence of a specified event. One of the eligible events is a participant's financial hardship. The rules applicable to these hardship distributions are less restrictive than for salary deferral accounts.

For hardships from employer-funded benefits, the plan must define hardship and establish rules that are applied in a uniform, consistent man-

ner. However, in order to simplify plan administration, some plan documents apply the more restrictive salary deferral hardship withdrawal requirements to hardship withdrawals from employer-funded accounts.

The plan may permit the entire vested employer-funded account balance to be distributed, including earnings. Employer qualified nonelective contributions (QNEC) and qualified matching contributions (QMAC), made for purposes of passing nondiscrimination testing, may not be distributed as in-service distributions unless the employee has attained age 59½. An exception applies for QNECs and QMACs credited prior to January 1, 1989 (or if later, plan years ending prior to July 1, 1989).

The rules for salary deferral hardship distributions are more complicated. Let's take a look at those rules.

Distributions From Deferral Accounts

The first requirement is that the withdrawal be on account of an immediate and heavy financial need of the participant. In addition, the withdrawal must not exceed the amount necessary to satisfy the need. These determinations are made in accordance with objective and nondiscriminatory standards set forth in the plan document.

Financial Need

The determination as to whether or not a participant has an immediate and heavy financial need is based on the relevant facts and circumstances of each case. However, the regulations provide a "safe harbor" list of events which will automatically be *deemed* to satisfy the financial need requirement. The list is as follows:

- Expenses for, or necessary to obtain medical care for the employee, the spouse or dependents (including a non-custodial child) that

would be deductible under section 213 of the Internal Revenue Code (IRC), regardless of whether the expenses exceed 7.5% 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 the next 12 months of post-secondary education for the employee, the spouse, children or dependents;
- Payments necessary to prevent the eviction of the employee from his principal residence or foreclosure on the mortgage on that residence;
- Payments for burial or funeral expenses for the employee's parent, spouse, child or dependent; or
- Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under IRC section 165, whether or not the loss exceeds 10% of adjusted gross income.

The last two items on the list were added by the final 401(k) regulations, effective for plan years beginning after December 31, 2005. Plans had the ability to incorporate the changes earlier, as of plan years ending after December 29, 2004, but only if all of the provisions of the final regulations were implemented at the same time. The hardship provisions of the final regulations can only be utilized after the plan document has been appropriately amended.

Plans may utilize the safe harbor definition of financial need or establish their own criteria under the facts and circumstances test. The regulations give some examples of what may reasonably be considered financial need, and certainly the safe harbor list can also serve as a guideline.

Satisfaction of the Financial Need

Once the existence of a financial need is established, a participant must show that a distribution from his salary deferral account is necessary to satisfy the need. Under the facts and circumstances test, the following items must be satisfied:

- The distribution must not exceed the amount of the need, plus any federal, state and local taxes and penalties that may result from the distribution, and
- There are no alternative means available. Alternative means includes assets of the employee's spouse and minor children that are reasonably available to the employee. The employer may rely on the employee's written statement that no other resources are available, absent specific knowledge to the contrary that the need can be satisfied by:
 - Reimbursement or compensation by insurance or otherwise;
 - Liquidation of employee's assets;
 - Cessation of elective or other employee contributions to the plan;
 - Other currently available distributions and loans from plans maintained by any employer; or
 - Borrowing from commercial sources on reasonable terms.

However, the employee would not be expected to take such other action if the effect would be to increase the need.

A plan can choose to utilize a safe harbor test in which case the distribution will be *deemed* necessary to satisfy the need if the following two conditions are met:

- The employee has obtained all other currently available distributions and loans from all plans maintained by the employer, and
- The employee is prohibited from making elec-

tive and other employee contributions to any plan maintained by the employer for at least six months after receipt of the hardship distribution.

The term "all plans of the employer" means all qualified and non-qualified plans. The six-month suspension rule does not apply to mandatory employee contributions to a defined benefit plan or to a health or welfare benefit plan. In plans that provide safe harbor matching contributions to avoid nondiscrimination testing, the suspension period cannot exceed six months.

Benefits Available For Distribution

Regardless of the amount of financial need, a hardship distribution cannot exceed the amount of available benefits in the participant's salary deferral account. Generally, the available benefits are limited to the aggregate contributions made by the participant up to the date of distribution, reduced by any prior deferral distributions. Earnings on salary deferrals are not included, other than those credited prior to January 1, 1989 (or if later, plan years ending prior to July 1, 1989).

EXAMPLE: Diane needs \$10,000 for the purchase of a primary residence. She has no other source of funds at her disposal. Her 401(k) plan allows participant loans as well as hardship distributions, and the rules require that all available loans be taken first. But the additional debt of a plan loan would disqualify her from obtaining the mortgage she needs to purchase the home. She is therefore approved for a hardship distribution.

The current value of Diane's deferral account is \$14,000, of which \$9,500 represents her aggregate contributions since she entered the plan in 2001. The maximum withdrawal Diane can take is \$9,500, and she would have to suspend contributions to the plan for the next six months in accordance with the provisions of her plan.

Taxation of Hardship Distributions

Hardship distributions are taxable in the year received and will be subject to an additional 10% early withdrawal penalty if the participant has not reached age 59½. Such distributions are not eligible for rollover to an IRA or another qualified employer plan. They are subject to 10% tax withholding which may be waived by the participant.

Hurricane Katrina Victims

On September 15, 2005 the Internal Revenue Service (IRS) and the Department of Labor provided unprecedented broad-based relief for those adversely affected by Hurricane Katrina. IRS Announcement 2005-70 provided guidelines for the relaxation of administrative rules governing plan loans and hardship distributions to Katrina victims and members of their families who participate in retirement plans. The relief made it easier for these participants to establish financial need by allowing plan administrators to rely on representations by the participant, absent

actual knowledge to the contrary. In addition, the minimum six-month contribution suspension period after receiving a hardship withdrawal was eliminated. Plans that didn't provide for loans or hardship distributions could process withdrawals regardless and amend the plan at a later date. The special rules applied to loans and hardship distributions made between August 29, 2005 and March 31, 2006.

Conclusion

The availability of hardship distributions from salary deferral plans is one of many factors that encourage employee participation. Knowing that the money can be withdrawn if needed provides a sense of security. The hardship rules are intended to limit distributions to times of serious financial need and support the long-term goal of saving for retirement. But the recent expansion of the hardship criteria illustrates that the rules are intended to be fair and keep pace with the changing needs of employees.

The information contained in this newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is provided with the understanding that our company is not engaged in rendering legal or tax advice. Legal or tax questions should always be referred to a qualified tax advisor such as an attorney or CPA.

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