Section 457(b) Plan Administrator's Guide
To Unforeseeable Emergency Withdrawals

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Section 457(b) Plans may (but are not required to) offer participants the ability to take an in-service withdrawal in the event of an "unforeseeable emergency." While 457(b) plans typically offer an unforeseeable emergency withdrawal option, most plan sponsors would agree that this feature is one of the most difficult to administer.

Why is unforeseeable emergency administration so difficult?

The source of the difficulty in administering 457(b) unforeseeable emergency provisions lies primarily with the law and related regulations. Unforeseeable emergency withdrawal provisions are difficult to administer because so many of the legal requirements are not well defined.

Regulations under Section 457(b) of the Code define an unforeseeable emergency as a severe financial hardship resulting from:

- an illness or accident,
- the loss of property due to casualty loss (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, *e.g.*, as a result of a natural disaster), or
- any other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the individual's control.

The IRS has not provided much guidance on the key parts of this definition. In particular, no substantial guidance on what is meant by the terms "severe" or "unforeseeable" has been issued. Plan administrators have been left with what amounts to a subjective facts and circumstances test for adjudicating unforeseeable emergency withdrawal requests.

Many plan administrators have tried to streamline and simplify administration by creating lists of events and expenses that are eligible or ineligible. While helpful, it is also clear that making such lists is an endless proposition because of the myriad of circumstances and situations the participants present when making withdrawal requests.

This Guide is intended to help plan sponsors understand the basic requirements and some best practices for the design and sound administration of this common but difficult to administer 457(b) plan feature.

Does the unforeseeable emergency withdrawal option need to be part of the plan document?

Yes. The 457(b) regulations make it clear that the unforeseeable emergency option must be a written provision in the plan document before it can be offered.

What are some common best practices for designing and administering 457(b) unforeseeable emergency withdrawal provisions?

As with other aspects of plan administration, consistency is important. Realize that plan sponsors set a precedent of sorts with each granted request, and that participants will expect similar treatment from their perspective for their situation. While consistency of administration is not a guarantee that each and every decision will satisfy IRS scrutiny, it is evidence of good faith compliance that may be helpful.

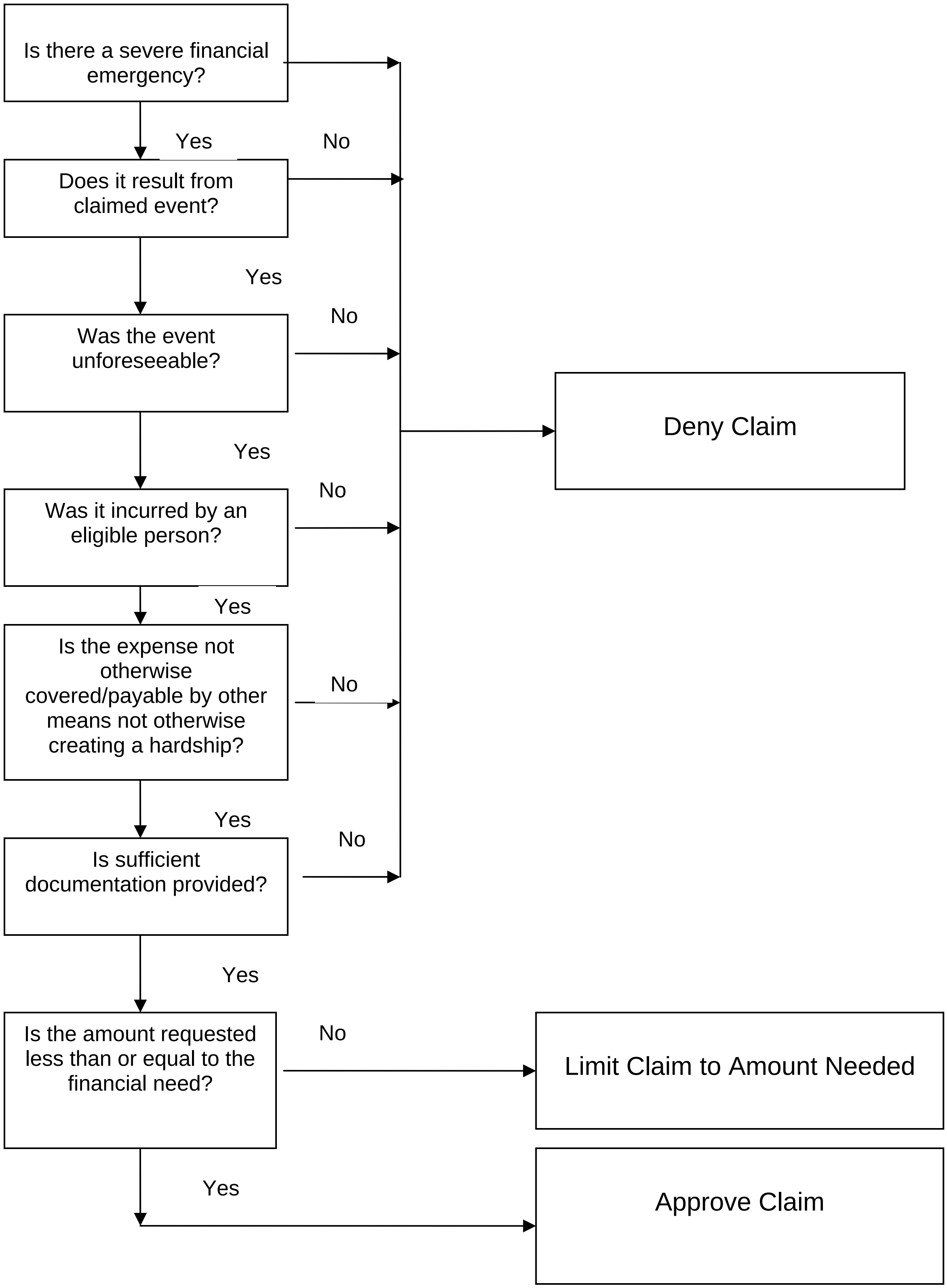
A written policy detailing the established procedures and objective standards for administering unforeseeable emergency withdrawal features is also advisable. Written policies need not (nor could such be expected to) address all the possible circumstances that may arise. However, a written policy that 1) identifies the process to be followed, 2) the standards to be applied and 3) circumstances that clearly qualify or do not qualify as eligible unforeseeable emergencies can help streamline administration.

Having a written unforeseeable emergency withdrawal policy also helps demonstrate good faith compliance to the IRS.

The written policy should be adopted by the plan fiduciaries and should clearly identify responsibilities that have been delegated to committees, staff or to third-party service providers and appeal procedures.

What are the requirements for reviewing unforeseeable emergency requests?

There are seven basic requirements that an individual must meet in order to be eligible for an unforeseeable emergency withdrawal under 457(b). The accompanying flow chart identifies each of these requirements and provides a process that administrators may wish to consider for reviewing unforeseeable emergency requests.


Is there a severe financial emergency?
Yes
No
Does it result from claimed event?
Yes
No
Was the event unforeseeable?
Deny Claim
Yes
No
Was it incurred by an eligible person?
Yes
Is the expense not otherwise covered/payable by other means not otherwise creating a hardship?
No
Yes
No
Is sufficient documentation provided?
Yes
Is the amount requested less than or equal to the financial need?
No
Limit Claim to Amount Needed
Yes
Approve Claim

What does severe financial hardship mean?
The 457(b) regulations do not define what constitutes a "severe financial hardship". Because IRS guidance has been limited in this area, administrative practices vary rather widely. Some practices have evolved that may be helpful to plan administrators. One of the clearer and more understandable approaches is to adopt something similar to the "immediate and heavy" standard used for administering the hardship distribution provisions under 401(k) and 403(b) plans. Under this standard, a 457(b) plan participant would have to show that the financial hardship is

- Immediate – The requested withdrawal is needed currently and not at some later date, and
- Heavy – The size of the resulting financial burden must be large enough to create a hardship to the individual. This is a subjective test and will depend on the facts and circumstances of each case. For example, a $1,000 uninsured medical bill for a person with family income of $15,000 per year is more likely be judged to be a heavy financial burden, while it may not be for an individual with family income of $150,000.

Some plan sponsors have used other standards, including requiring the financial hardship to be "catastrophic", "sudden, or "unexpected". These are all permitted under federal law. Regardless of what standard a plan uses to define what a "severe" financial hardship is, it will mean applying a facts and circumstances test.

Does the severe financial hardship have to be directly caused by the unforeseen event?

The 457(b) regulations state that the financial hardship must be the result of the events in question. There has been no further IRS guidance as to how connected the event has to be to the claimed financial hardship. Plan administrators should require, however, that the individual identify the emergency event and explain how the event contributed to the financial hardship. Some causal connection between the event and the financial hardship must be shown.

What does "unforeseeable" mean?
The regulations identify the following as events that will be considered unforeseeable:
- Illness
- Accident
- Casualty loss

Illness and accidents are generally understandable and recognizable events. Casualty is not further explained by the IRS, but is commonly understood to include other sudden, unexpected or unusual events, such as fires, storms, lightning, earthquakes and other natural or weather related disasters.

Unfortunately, except for the three events noted above, there really is no easy test or clear standard to determine the existence of an unforeseeable emergency. The 457 regulations state that the existence of an unforeseeable emergency is "to be determined based on the relevant facts and circumstances of each case" – in other words by your interpretation and best judgment. Some questions to ask in every case include:

- Were events beyond the individual's control?
- Could the situation have been anticipated, avoided or budgeted?

While applicable federal law and related regulations do not identify any formal "reasonableness" standard for determining whether an emergency was unforeseeable, it is clear that the IRS expects unforeseeable emergency withdrawal provisions to be administered under objective standards that are consistently applied. Plan sponsors should establish policies that determine unforeseeability from the perspective of a reasonable and prudent person.

Whose emergency does it have to be?

The illness, loss, or other unforeseeable emergency can be that of:
- the participant
- the participant's spouse
- the participant's dependent for Code Section 152 tax purposes (e.g. a minor child, relative or other individual who lives with the participant full time and receives over half of his or her support from the participant) or
- the participant's beneficiary under the Plan. (The Pension Protection Act of 2006 added this optional category.)

Has the IRS provided any other guidance or examples of what is or may be an unforeseeable emergency?

The IRS has specifically ruled out the elective purchase of a home or college tuition as unforeseeable emergencies. (Note that these two events are probably eligible as "financial hardship" in-service distribution events for a 401(k) or 403(b) plan.)

The IRS has also said that foreclosure or eviction, medical expenses, and funeral payments **may** be, but are not necessarily always, unforeseeable emergencies.

What are some examples of events that are generally considered not to be unforeseeable emergencies?

The following are examples of expenses that, standing on their own, ordinarily would not qualify as a severe financial hardship because there is no unforeseeable emergency involved. These are situations where the individual 1) had significant control or 2) could have reasonably and prudently anticipated, avoided or budgeted for the event.
- Cost of education/tuition
- Normal monthly expenses – e.g., utility bills, mortgage or rent payments
- Payment on credit cards or loans
- Payment of federal, state, local or property taxes

- Elective purchase, maintenance or remodeling of a home or other real estate
- Costs associated with divorce or separation
- Purchase of automobile other transportation expenses
- Automobile or appliance maintenance
- Elective or cosmetic surgery
- Routine medical, dental or orthodontic services
- Bankruptcy
- Legal judgments and legal fees
- Investment losses
- Gambling losses
- Wage garnishment
- Costs of adoption
- Child support payments

It is important to note, however, that where there is a demonstrated unforeseeable emergency, some of these expenses may be considered as a severe financial hardship. For example, if a natural disaster strikes an area and an individual loses their house and their job, they could ask for an unforeseeable emergency distribution. The basis for this unforeseeable emergency distribution would be a loss of income that the participant could use to cover ordinary expenses, including credit card payments. The unforeseeable emergency distribution could not exceed the participant's income loss. An unforeseeable emergency distribution could also be granted in this example to buy a new primary residence. However, the unforeseeable emergency distribution would have to be reduced by any insurance and other benefits the participant receives from other sources related to the housing loss. This illustrates why it is so difficult to develop comprehensive lists of situations and expenses that will be eligible under the unforeseeable emergency rules and why it is so important to develop clear and consistent standards and processes for making decisions in this area.

Does an individual need to use other financial resources first before seeking an unforeseeable emergency withdrawal?

Yes, the regulations provide that the individual should only withdraw assets intended as retirement savings in the Plan as a last resort. To that end, the following requirements must typically be met:

- Insurance coverage is either not available or is insufficient to cover the financial need caused by the unforeseeable emergency.
- The need cannot be satisfied by taking a loan from the Plan, from other plans of the employer, or from commercial lenders.
- The need cannot be met by stopping contributions under the Plan and/or any other plan of the employer with elective deferrals.
- The need wouldn't be satisfied through the liquidation of the participant's assets, as long as the liquidation itself doesn't impose further unreasonable hardship.

What kind of documentation is generally required with an unforeseeable emergency withdrawal request?

The decision to grant or deny an unforeseeable emergency withdrawal request must be based on sufficient evidence indicating the emergency is extraordinary and unforeseeable. The participant must file a written request and provide all necessary and requested supporting proof and documentation. (On their website listing of top 403(b)/457(b) compliance issues, the IRS lists inadequate documentation, lack of proper internal controls, and distributions that exceed the amount needed as common violations in unforeseeable emergency withdrawal administration.)

While the IRS has not provided guidance as to how much evidence is necessary, it is relatively clear that the mere statement by an applicant without an offer of proof is likely insufficient. Some examples of commonly required documentation include:

- A written explanation of the circumstances giving rise to the withdrawal request
- Explanation of Benefits (EOB) for medical bills.
- Written notice of eviction/foreclosure
- Pay stubs
- Worker’s compensation or disability payments
- Bills, receipts, or statements for funeral, repairs to home, attorneys’ fees, etc.
- Personal financial statements
- Loan denial letters from commercial lenders
- Foreclosure or eviction notices/documents

Other documentation or proof may be necessary depending on the nature of the emergency event and the financial hardship.

Can adding a plan loan feature decrease the burdens of administering an unforeseeable emergency feature?

Yes. Plan loans can be offered by 457(b) plans and are being increasingly considered as an alternative way for participants to gain access to their accounts when needed. Federal law and regulations allow loan features to be offered without requiring participants to meet the “extraordinary and unforeseeable emergency” standard that is so difficult to administer.

Plan sponsors concerned about making participant retirement savings too available can impose limitations on the availability of plan loans. For example, a plan sponsor could require that plan loans can be made available only for “hardships” permitted for 401(k) and 403(b) plans.

Adding a plan loan feature may lessen the time and effort spent administering unforeseeable emergency withdrawal requests. However, plan loans add their own complexities that should be assessed carefully before being added, including administering loan repayments and defaults.

What taxation and reporting rules apply to unforeseeable emergency distributions?

Unforeseeable emergency withdrawals are taxable to the participant as ordinary income. Under IRS Notice 2003-20, unforeseeable emergency withdrawals are non-periodic payments that are reported on Form 1099R for federal and state income tax purposes. Unforeseeable emergency distributions are not eligible rollover distributions and are subject to withholding under § 3405(b) at a 10-percent rate, unless the recipient elects not to have withholding apply.

Can an unforeseeable emergency withdrawal be paid back?

No. An unforeseeable emergency withdrawal is not a loan. Further, because the participant may not be allowed to contribute for up to 12 months, the participant will likely miss out on the opportunity to make even regular contributions until the plan allows contributions to begin again. However, subject to the regular annual deferral limits, once the participant is again eligible to contribute, additional contributions could be made at that time to make up for the amounts withdrawn.

Does an unforeseeable emergency withdrawal affect the amount that can be deferred in the year of the hardship?

No. A participant may still contribute up to the regular deferral limit for that year. Again, however, because the plan may prohibit participant to make contributions for up to 12 months, the participant most likely will not reach the limit for that year.

Does an unforeseeable emergency withdrawal affect the amount a participant can contribute under the Age 50 or 3-year catch up feature?

No. The unforeseeable emergency withdrawal does not reduce the amount of a participant's Age 50 or 3-year catch-up calculation.

About the Authors:
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