

Similarities and Differences of Hardship Distributions Among Defined Contribution Plans

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Introduction

Section 401(k), 403(b) and 457 plans may permit participants to take in-service withdrawals because of situations that result in a financial hardship. Although the requirements for distributions for financial hardship differ between 457 and 401(k)/403(b) plans, any plan that permits financial hardship distributions must apply a two-part test to the participant's request before making this distribution:

1. The Unforeseeable Emergency or hardship must create a heavy and immediate financial need that cannot be relieved or met from other sources, and
2. The amount of the distribution will not exceed the amount of the financial need.

457 Unforeseeable Emergencies

Section 457 permits distribution to a participant or beneficiary because of financial need as a result of an Unforeseeable Emergency (UE). The conditions for what qualifies as an UE must be defined in the Plan Document as a severe financial hardship for the participant or beneficiary resulting from:

- Illness or accident of the participant, beneficiary or the participant's or beneficiary's spouse, or dependents.
- Loss of property due to casualty - including the need to rebuild a home after damage such as a natural disaster that is not covered by insurance.
- Events beyond the participant's or beneficiary's control which may include:
 - Eviction or foreclosure on primary residence.
 - Need to pay medical expenses - including prescription drug costs and non-refundable deductibles.
 - Need for participant or beneficiary to pay funeral expenses of a family member.

Situations that may qualify as an UE are not as broad as those permitted for 401(k) and 403(b) hardship distributions. For example, the final 457 regulations state that payment of college tuition or purchase of a home - although considered eligible for hardship distributions from 401(k) and 403(b) plans - would not generally qualify as an UE distribution from a 457 plan.

Determination for what qualifies as an UE distribution is based on the relevant facts of each case. Unlike 401(k) and 403(b) plans, there are no safe harbor standards that may be used in making these determinations. UE distributions may be made only for those amounts not already covered by:

- Reimbursement or compensation from insurance,
- Liquidation of participant's assets provided such liquidation will not cause a financial hardship, or
- Cessation of deferrals under the plan.

Instead of requesting documentation from an employee about his/her available resources etc. and then evaluating this information, the employer/administrator may rely on a written statement from the employee that the employee's financial need cannot be relieved except by a distribution from the plan. The employer may not rely on an employee's written statement if the employer has actual knowledge that the employee representations made in the statement are not true.

The distribution to satisfy the financial hardship caused by the UE is limited to the amount needed to satisfy the financial hardship but can be increased to cover federal, state, or local income taxes or penalties that are expected to result from this distribution. Unlike 401(k)/403(b) using the safe harbor distribution standard, 457 plans are not required to suspend deferrals for a period of time after an UE distribution as long as the plan document provides for the this flexibility. **Where the money comes from is important.** The IRS final regulations permit 457 plans to establish two accounts for rollover contributions into the plan: one for 457 rollovers and one for non-457 rollovers. Depending on plan provisions, the 457 contribution account and the 457 rollover accounts could be used first to make UE distributions before using a non-457 rollover account that may be subject to an early distribution tax. (Beneficiaries are not subject to this tax.)

UE distributions from 457 plans are generally not subject to the 10% early distribution tax that applies to qualified and 403(b) plan participants who have not reached age 59½. However, any funds that are rolled into the 457 plan from a qualified 401(k) or 403(b) plan, or IRA may be subject to the 10% early distribution tax - unless an exception that applies to qualified plans would be applicable.

403(b) and 401(k) Hardship Distributions

The criteria for financial hardships are the same for both 401(k) and 403(b) plans. Unlike 457 plans, financial hardship from these plans can result from foreseeable events and voluntary choices. These plans must still apply the same two-part test as 457 plans by determining if:

1. There is a need that causes a severe and immediate financial hardship, and
2. The financial hardship can be relieved with a distribution from the plan.

The methodology in making the hardship determination for these plans can be more complex because both parts of the test can be met using a facts-and-circumstance determination, a deemed Safe Harbor standard, or a combination of the two. The plan does not have to use the same methodology for both parts of the test.

For example, the financial-needs test could use the safe harbor deemed standard (most do) and either a safe harbor or facts-and-circumstance evaluation to determine if a plan distribution will satisfy the financial hardship.

Safe Harbors

The Safe Harbor method deems a financial hardship as "an immediate and heavy financial need" for any or all of the following:

- Expenses for medical care of employee, spouse, or employee's dependents
- Costs related to the purchase of a principal residence, but not the mortgage payments
- Cost of tuition payments related to educational fees and room-and-board expenses for the next 12 months of post-secondary education for the employee, spouse, children or dependents
- Payments necessary to prevent eviction from the employee's principal residence or to prevent foreclosure on the mortgage on the employee's principal residence.

The Safe Harbor deems a plan distribution will satisfy the financial need, if all the following requirements are met:

- Distribution cannot exceed financial need but may be increased for anticipated federal, state, local taxes and penalties.
- All non-taxable loans and other available plan distributions must be taken first before taking a hardship distribution from all qualified and non-qualified plans of the employer.
 - Plans are not required to have loan programs.
 - Even if the plan does have a loan program, participants are not required to take plan loans if these loans will increase financial need.
- Participants must suspend deferrals to all plans of the employer for at least 6 months after receiving a hardship distribution. Participants are not required to cease mandatory employee contributions to defined benefit or health and welfare plans.

Facts-and-Circumstance Determinations

If a facts-and-circumstance determination is used instead of the safe harbor definition of financial hardship, the plan must contain the objective requirements used to determine the financial hardship.

For example, the need to pay funeral expenses of a family member would generally constitute an immediate and heavy financial need. On the other hand, a distribution to pay for a boat or television would not generally constitute an immediate and heavy financial need that would be eligible for a hardship distribution.

Prior to making a distribution from the plan, all assets of the employee, the employee's spouse, and minor children that are available to the employee to meet the financial need may have to be considered depending on all relevant facts-and-circumstances of a particular case. An employee's resources could include a vacation home and/or jointly held property. Property held for the employee's child under an irrevocable trust, or under the Uniform Gift to Minors Act would not be considered a resource of the employee.

The employer/administrator may rely on the written statement of the employee that the financial need cannot be relieved by other means - unless the employer has knowledge to the contrary that the need cannot be reasonably relieved by:

- Reimbursement or compensation from insurance.
- Liquidation of employee's assets.
- Cessation of elective deferral or employee after tax contributions under the plan.
- Other distributions or non-taxable loans from any of the employer's plans.
- Borrowing from commercial source at reasonable commercial rates.

Employees need not take counter-productive actions that would increase financial need. For example, the employee would not be required to take a plan loan to purchase a home if the plan loan would prevent the employee from obtaining the necessary financing to purchase the home.

What Can Be Distributed?

All elective deferrals, but not the earnings on those deferrals, may be distributed for financial hardship. Depending on the type of plan and the terms of the plan, employer contributions and earnings may also be available for hardship distributions.

As opposed to Section 457 UE distributions, Section 401(k)/403(b) hardship distributions prior to age 59½ are subject to a 10% early distribution tax. Of course, federal and other applicable income taxes and penalties also apply. Hardship distributions are not eligible for rollover.

Putting It All Together

The following examples use a Safe Harbors approach to determining financial need and demonstrate how facts-and-circumstance and safe harbor are then used to determine if a plan hardship distribution will satisfy the financial need.

Example 1

Employer Q maintains a 401(k) and no other plans. The plan does not have a loan provision but does permit in service distribution of elective deferrals for hardship using the Safe harbor deemed and heavy financial need standard. A facts-and-circumstance evaluation is used to determine if the financial need can be satisfied by a distribution from the plan.

Allen has a 401(k) account balance of \$50,000 attributable to elective deferrals and earnings. His total elective deferral contributions are \$20,000. He has requested a hardship distribution of his elective deferrals of \$15,000 to pay for the 6 months of his daughter's college tuition and room and board expenses. At the time of this request, the only other asset he has is a \$10,000 savings account.

Facts-and-Circumstance Determination Without Written Statement From Employee

The plan will need to consider Allen's situation and resources to determine if a plan distribution and how much of a plan hardship distribution can be made. The employer does not rely on a written statement from Allen that his need cannot be relieved by other sources and the plan will have to evaluate his other resources.

Since his \$10,000 savings account is a resource that is reasonably available to him, it must be considered when determining the amount necessary to be distributed from the plan to satisfy his financial need. After evaluating Allen's situation the plan administrator determines that he may receive a distribution of only \$5,000 from the plan plus any amount to pay anticipated taxes and penalties.

Example 2

Burt is in the same plan as Allen and has an account balance of \$25,000 attributed to his elective deferrals and earnings. He has made total elective deferral contributions of \$15,000 and has not received any other distributions from the plan. He needs \$10,000 to pay for 6 months of college tuition and room and board for his son.

Facts-and-Circumstance Determination With Written Statement From Employee The employer now accepts written representation from employees about their other resources instead of requiring this detailed information about these resources. Burt provides his employer with a written statement that his need for a hardship distribution cannot be met by:

- Reimbursement or compensation from insurance.
- Liquidation of assets available to him.
- Cessation deferrals to the plan.
- Other distributions from plans maintained by the employer or any other employer.
- Borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

Since Burt's employer has no actual knowledge that Burt's written statement is not true, his employer can rely on the representations in Burt's written statement. The plan may therefore give Burt a \$10,000 hardship distribution of his elective contributions plus any amount necessary to pay reasonably anticipated taxes and penalties.

Safe Harbor/Safe Harbor

Same as Example 1, except Allen's employer applies safe harbors to meet both parts of the test for making hardship distributions. Since Allen is not eligible for a plan loan or any other distribution from the plan and the plan suspends Allen's elective contributions for 6 months after making the hardship distribution, this distribution is deemed necessary to satisfy Allen's immediate and heavy financial need. He will not have to liquidate his savings account and may receive a \$15,000 hardship distribution from the plan plus any anticipated taxes and penalties.

Sources used for this article:

457 Final Regulations

401(k) Proposed Regulations

Final 414(v) Catch-up Regulations

ERISA Outline Book 2003 Edition, Sal A. Tripodi, J.D. LL.M

About the author:

A Plan Technical Consultant with Nationwide Retirement Solutions, Joann Albrecht, CPC, QPA, is our "go-to" person on legislative and regulatory issues that may affect the deferred compensation plans Nationwide administers.

Joann has extensive experience with both the private and public sector retirement plans including qualified plans, 403(b), and 457 plans. She is a credentialed member of the American Society of Pension Actuaries (ASPA), and serves on several ASPA committees including its Tax Exempt and Government Plans Committee and has been a speaker at several ASPA benefit conferences.