



## **HARDSHIP DISTRIBUTIONS: SOMETIMES YOU NEED SOME OF THE MONEY BEFORE YOU RETIRE**

Hardship distributions have been a part of tax qualified 401(k) plans and, to a lesser extent, profit sharing plans, for many years. Coupled with plan loans, they offer a “safety net” for participants who either unexpectedly find urgent immediate financial needs or who wish to use the retirement plan as a savings vehicle for uses other than just retirement. Purchasing a first home and putting the kids through college can be financed through the company retirement plan, if hardship distributions are permitted. While some profit sharing plans permit hardship distributions, they are more common in 401(k) plans because they often encourage employees to defer salary into the plan since the employee has the knowledge that at least some of their money is available in a financial pinch.

Offering hardship distributions through a 401(k) plan is so common that the Treasury Dept. has provided “safe harbor” hardship distribution provision rules. If these rules are incorporated into the plan documents, employers are assured that the government will not “second guess” Plan Administrator actions in determining who receives distributions and in what amounts. Regardless of whether safe harbor rules are built into the plan, financial hardship distributions must be made “on account of an immediate and heavy financial need and must not exceed the amount necessary to satisfy that need,” according to federal regulations.

The safe harbor rules provide the following six reasons\* as the exclusive reasons for a hardship distribution:

- Medical care expenses for the participant or his immediate family;
- Purchase of the participant’s principal residence;

- Post secondary education expenses (up to 12 months per distribution) for the participant or his immediate family;
- Payments to prevent eviction from the participant’s residence or to prevent foreclosure on the mortgage on that residence;
- Burial expenses for a spouse, parent, child, or other dependents;
- Repair of damage to the participant’s principal residence that qualifies as a casualty deduction for income tax purposes.

*\* A 401(k) plan that permits these six (6) hardship distribution provisions may also be amended to allow for hardship distributions related to the medical, tuition, and funeral expenses of a primary beneficiary, regardless if that primary beneficiary is part of the immediate family.*

These same safe harbor rules require the following:

- Distribution amounts may not exceed the amount necessary, but can include a provision for applicable taxes and penalties (a 10% federal penalty tax can apply if the participant is under age 59 ½);
- The participant has received all currently available distributions from all of the employer’s plans and has applied for a loan, if the plan offers one and if the loan would not increase the employee’s need;
- The plan must suspend salary deferrals for a period of at least six months.

While hardship distributions can reduce the accumulated retirement nest egg, there are times when financial needs well before retirement age can be met with accumulated assets normally meant for retirement.



## **UPDATE: TREASURY DEPARTMENT ISSUES PROPOSED REGULATIONS RELAXING RULES FOR REDUCING OR STOPPING 401(k) SAFE HARBOR CONTRIBUTIONS**

Our May 2009 newsletter provided a detailed look at the problems encountered by some employers who want to reduce or eliminate non-elective “safe harbor” employer contributions mid-year. Federal regulations permitted an employer to reduce or stop these contributions in the middle of the year only if the *entire plan was terminated*. Our article mentioned the likelihood of federal relief and we are pleased to report that on May 18, 2009, Treasury issued a proposed change to the regulations and stated that they apply to any plan amendments adopted after May 18. In other words, employers are free to rely on the proposed rules, even if final regulations are more restrictive.

The proposed regulations allow mid-year reduction or elimination of safe harbor non-elective employer contributions if the employer suffers from “substantial business hardship.” Employees must be notified of the reduction 30 days in advance, and offered the opportunity to change their rate of salary deferrals. Furthermore, the plan must be amended to provide the required non-discrimination tests be satisfied for the entire plan year using the “current year” testing method. “Substantial business hardship” is determined by the IRS based on the facts and circumstances. These include whether:

- The business is operating at a loss;
- There is substantial unemployment or underemployment in the industry;
- Sales and profits are declining or depressed;
- It is likely the plan will not be continued unless the contribution reduction is permitted.

We are pleased that Treasury heeded the pleas of many in the private sector and believe this development represents a step forward in maintaining and fostering our private retirement system.

## **PENSION BENEFIT GUARANTY CORPORATION (“PBGC”) RECANTS: MODIFIES STANCE ON EMPLOYER REPORTING QUARTERLY FUNDING CONTRIBUTIONS**

As we predicted in last month’s newsletter, the PBGC partially withdrew from its position that all employers with PBGC covered plans report cases where they fund their pension obligation less frequently than quarterly. In many cases, the “failure” is deliberate, due to convenience or because of an inability to ascertain the necessary amounts within the time available for making the contribution. On April 30, 2009, the PBGC reversed its earlier February 20, 2009 position, and conceded that plans covering fewer than 25 participants were generally exempt from reporting this event. Plans with between 25 and 99 participants in the prior plan year are permitted to file a single annual simplified report, instead of one report for each missed contribution. This relief is offered to employers who do not make quarterly contributions for reasons other than financial inability to do so.

This development avoids unnecessary and costly reporting activities that would rarely provide the PBGC with information necessary to carry out their responsibilities in assuring the financial stability of America’s pension plans.



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