january/february 2014

Retirement PLAN news

Hardship distributions

Retirement plans are not required to provide hardship distributions. However, many profit sharing plans, including 401(k) plans, do. If a participant in a plan with a hardship provision has an immediate and heavy financial need, and the need matches the plan's definition of hardship, the participant may be eligible for a distribution (restrictions and limits apply).

It's natural to feel bad when someone is in need. However, authorizing a plan distribution that does not meet the requirements can disqualify the entire plan and lead to adverse tax consequences for plan participants and for the plan sponsor. It is important for sponsors to understand the hardship rules and to have procedures in place for making distributions and documenting a participant's need in a manner that will satisfy the IRS in case the plan is chosen for examination.

Six safe harbor reasons

There are six safe harbor reasons that satisfy the immediate and heavy need requirement in most prototype plans. They are:

1. Unreimbursed medical expenses deductible under Internal Revenue Code Section 213(d) for the participant or the participant's spouse, dependents, or beneficiaries
2. The purchase of a principal residence
3. Tuition and related educational fees and room and board expenses for up to the next 12 months of post-secondary education for the participant or the participant's spouse, children, dependents, or beneficiaries
4. To prevent eviction from or foreclosure on the principal residence
5. Funeral expenses for the participant or the participant's spouse, dependents, or beneficiaries
6. Expenses for the repair of a principal residence due to hurricane, flood, and other casualty deduction reasons

Other sources first

If a participant has other resources available that can satisfy his or her financial need, those should be used first. For prototype plans, all other plan distributions must be taken before a hardship may be requested, including a participant loan. **Note:** There are two exceptions to this requirement. A loan would not have to be taken first if 1) the loan repayments would make the hardship worse or 2) a participant is purchasing a principal residence and taking a plan loan would prevent the participant from getting financing.

For individually designed plans or volume submitter plans using the "facts and circumstances test" to determine hardship, participants must first make use of all reasonably available personal assets, regardless of whether they are plan related.

Hardship documentation

The plan sponsor may rely on the employee's written representation that a hardship exists (unless the sponsor has

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2014 COLA limits

The IRS has released the cost-of-living adjustments (COLAs) applicable to the dollar limitations for pension plans (and other items) for the 2014 tax year.

IRS Limits	2014	2013
401(k), SARSEP, 403(b), and 457 plan deferrals/catch-up	$17,500/ $5,500	$17,500/ $5,500
SIMPLE plan deferrals/ catch-up	$12,000/ $2,500	$12,000/ $2,500
Compensation defining highly compensated employee*	$115,000	$115,000
Compensation defining key employee/officer	$170,000	$165,000
Defined benefit plan limit on annual benefits	$210,000	$205,000
Defined contribution plan limit on annual additions	$52,000	$51,000
Maximum compensation limit for allocation and accrual purposes	$260,000	$255,000
IRA contributions/catch-up	$5,500/ $1,000	$5,500/ $1,000

* 2013 amount for use in 2014 plan year tests

Traditional IRA changes. There also are changes in 2014 to the adjusted gross income (AGI) "phaseout" limits for determining what portion of contributions to a traditional IRA are deductible. For taxpayers who are active participants filing a joint return (or qualified widow(er)s), the deduction begins to phase out with a combined AGI of $96,000 (up from $95,000). For taxpayers other than "married filing separate returns," the deduction phaseout begins at $60,000 AGI (up from $59,000). For a taxpayer who is not an active participant but whose spouse is an active participant, the deduction phaseout begins at a combined AGI of $181,000 (up from $178,000).

Roth IRA changes. There is also an AGI-based limitation for determining the maximum Roth IRA contribution. For married taxpayers filing a joint return (or qualified widow(er)s), the contribution phaseout begins at $181,000 (up from $178,000). The AGI phaseout for single taxpayers begins at $114,000 (up from $112,000).

Hardship distributions

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knowledge to the contrary). However, the IRS expects the employer to gather documentation so the sponsor will be able to verify that the hardship exists. The following examples demonstrate some of the challenges in gathering appropriate documentation.

Example 1: Mark requests a hardship distribution for tuition expenses. As documentation, he provides a list of courses available at a local university, draws circles around the classes he plans to take, and provides a total tuition amount. What Mark should provide is an actual tuition bill from the university as documentation of his hardship.

Example 2: Suzanne requests a hardship distribution for unreimbursed medical expenses after having plastic surgery to remove a deformity. To understand whether this qualifies for a hardship, look at how the IRS defines "medical care" for hardship distribution purposes. If it meets that definition, it is eligible.

"Medical care" for hardship withdrawal purposes is defined by reference to Internal Revenue Code Section 213(d)(1), which states: "*The term 'medical care' means amounts paid –*

A. For the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,

B. For transportation primarily for and essential to medical care referred to in subparagraph (A),

C. For qualified long-term care services (as defined in Section 7702(B)(b)), or

D. For insurance (including amounts paid as premiums under Part B of Title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraph (A) and (B) or for any qualified long-term care insurance contract (as defined in Section 7702(B)(b))."

For hardship distribution purposes, unreimbursed medical expenses that meet the above definition are considered for hardship without regard to whether the expense exceeds 10% of the individual's adjusted gross income.

Note: For unreimbursed medical expenses to be tax deductible on an individual's federal income-tax return, they must exceed 10% of the individual's adjusted gross income (AGI) as of 2013. (Prior to 2013, the threshold was 7.5% of AGI.) IRS Publication 502, *Medical and Dental Expenses*, is issued annually to provide taxpayers with guidance in preparing their tax returns. The publication is also useful for plan sponsors because it delineates the rules for unreimbursed medical expenses that qualify for a hardship distribution as well as a tax deduction.

Hardship compliance

The IRS recently published some tips on hardship distributions for plan sponsors on its website. The IRS also describes some of the most common compliance errors that have been discovered during plan audits and explains how to avoid them.

Following is an overview of the IRS tips and some additional insights for plan sponsors.

Plan sponsor missteps

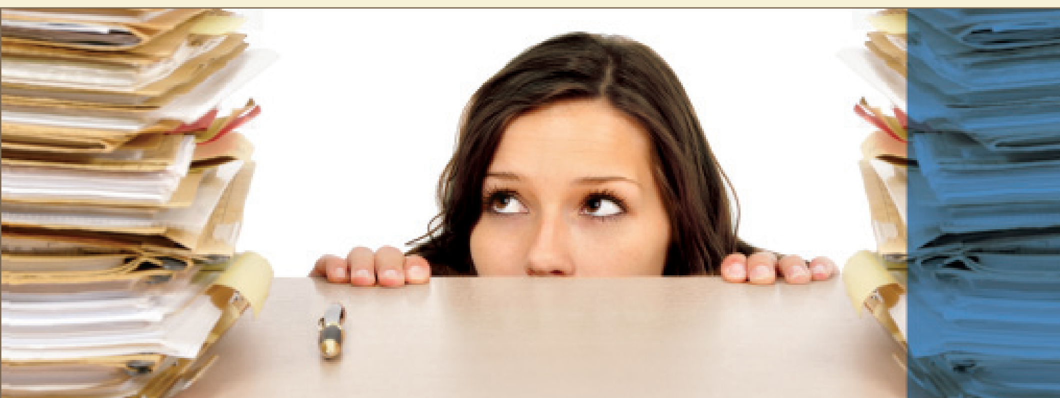
IRS agents have found that some plans make hardship distributions to participants even though their plan documents do not permit hardship distributions. Fortunately, this type of error may be corrected under the IRS's Self Correction Program by adopting a retroactive plan amendment to allow hardship distributions.

Agents also found that some plans make hardship distributions available for reasons not permitted under the plan. For example, if a plan only allows hardship distributions to pay tuition and related expenses, then it cannot permit hardship distributions for other purposes, such as unreimbursed medical expenses or the purchase of a principal residence. This is not a problem with a prototype plan, since all allowable safe harbor reasons are provided and employers are not given the option of choosing specific hardship reasons.

Avoiding errors

To avoid these types of errors, plan sponsors should carefully read the plan document to verify that the plan has hardship provisions in the first place and review what they are. Plan sponsors should conduct a thorough review of their plan's terms by focusing on these questions:

- Does the plan document allow participants to take hardship distributions?
  - Note that hardship distributions are not a protected benefit and may be removed prospectively by a plan amendment.
- Is the plan's definition of a hardship clearly defined?
- What are the procedures employees must follow to request a hardship distribution?
  - They should be clear and easy to follow.
  - They should explain the safe harbor reasons for receiving a hardship distribution.
  - They should explain the requirement that other assets must be taken first.
- Does the plan place any limits on the amount and type of funds that can be used in a hardship distribution from an employee's account?
  - The amount of a hardship distribution is limited to the heavy and immediate financial need plus the taxes that will be due on the hardship distribution.
  - Elective deferrals may be withdrawn but not earnings on deferrals after 1988.
  - A plan may permit participants to take vested nonelective contributions and matching contributions as hardship distributions.
  - A plan may not permit participants to take qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), or safe harbor 401(k) contributions as hardship distributions.
  - A plan may permit rollovers and transfers to be withdrawn as hardship distributions.



Documentation tips

Participants must be able to provide documentation that proves there is a hardship. And plan administrators are required to verify that the documentation will establish that a participant has an immediate and heavy financial need. However, the IRS has never actually provided guidance on what it considers acceptable documentation. If a plan is audited, the IRS agent will look for documentation that the plan sponsor confirmed that the employee requesting the hardship had exhausted other permitted plan distributions, such as a plan loan, and that the hardship distribution didn't exceed the amount necessary to satisfy the participant's immediate and heavy financial need.

Applying electronically

The popularity of arranging for a hardship distribution electronically is growing. As part of the process, a participant may self-certify that he or she has met the plan's hardship distribution criteria. However, the fact that the distribution application was processed electronically does not relieve a plan sponsor of the need to gather documentation as proof of the validity of the applicant's immediate and heavy financial need. Once the participant has applied for a hardship distribution electronically, it is recommended that the plan sponsor gather copies of the supporting documentation. The IRS indicated that agents will look for documentation that supports the participant's request and proves that the plan sponsor's hardship distribution process is in compliance.

You can link to the IRS articles on hardship distributions at *www.irs.gov/Retirement-Plans/Hardship-Distribution-Tips-For-You-and-Your-Plan-Participants* and *www.irs.gov/Retirement-Plans/Examination-Tips-for-Hardship-Distributions.*

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RECENT developments

2014 plan document news

Preapproved defined contribution (DC) restatement: Preapproved DC plans (i.e., master, prototype, and volume submitter) are required to adopt an updated plan document every six years. Plan documents revised for the Pension Protection Act of 2006 (PPA) and subsequent law changes were submitted to the IRS before April 2, 2012. The IRS will announce when plan documents will be approved and what the exact employer adoption dates will be in early 2014. It is anticipated that employer adoption of the PPA document will begin May 1, 2014, and run for a two-year period until April 30, 2016.

Preapproved defined benefit (DB) restatement: These plans are also on a six-year restatement cycle, but they lag behind the DC plan cycle by two years. DB plan document drafters must submit plans to the IRS by January 31, 2014. Document approval is expected to follow in early 2016, and the PPA restatement period for employers to adopt updated preapproved DB plans will begin in May 2016.

Individually designed plans: These defined contribution and defined benefit plans are rewritten every five years. The five-year cycle is generally based on the last digit of the sponsor's employer identification number (EIN). The current PPA restatement cycle C (for plan sponsors with an EIN ending in 3 or 8 and governmental plans) ends on January 31, 2014. Cycle D (for plan sponsors with an EIN ending in 4 or 9 and multiemployer plans) opens February 1, 2014, and ends January 31, 2015.

Preapproved 403(b) plans: For the first time ever, prototype and volume submitter 403(b) plan documents will be preapproved by the IRS. The expected timeline at this point is for document drafters to submit their plans for IRS review by April 30, 2014. If the timetable for preapproved 403(b) documents is similar to that of other preapproved documents, the review process would be completed sometime in 2016 and employers would have until sometime in 2018 to restate their existing documents.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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