

LR
#12

HARDSHIP WITHDRAWALS: Provide a Uniform Definition of a Hardship Withdrawal from Tax-Advantaged Retirement Arrangements

TAXPAYER RIGHTS IMPACTED¹

- *The Right to a Fair and Just Tax System*

PROBLEM

The Internal Revenue Code (IRC) contains a myriad of tax-advantaged retirement arrangements to encourage taxpayers to save for retirement.² While these planning vehicles help taxpayers save for retirement, they are subject to differing sets of rules regulating eligibility, contribution limits, tax treatment of contributions and distributions, withdrawals, availability of loans, and portability. TAS has discussed in prior reports the problems that such complexity may cause to both retirement plan administrators and participants.³

Particularly confusing are the rules governing distributions made before age 59½. Some tax-advantaged retirement arrangements allow participants to take an early distribution upon the event of a hardship without being subject to the ten percent additional tax imposed by IRC § 72(t). However, these various arrangements do not uniformly apply these so-called “hardship withdrawal” provisions.

IRC § 72(t) does not contain an exception to the ten percent additional tax for taxpayers whose last resort to pay for necessary living expenses is to liquidate their qualified plan. The lack of an exception negatively impacts low income taxpayers (those at or below the 250 percent of the federal poverty guidelines⁴) and those facing severe financial hardship resulting from an extended period of unemployment.⁵

Because the hardship withdrawal provisions do not apply uniformly to all qualified plans, taxpayers’ *right to a fair and just tax system* is compromised⁶ — that is, the type of qualified plan a taxpayer is participating in should not impact his or her ability to receive a hardship withdrawal. The current rules for

1 See Taxpayer Bill of Rights, available at www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

2 The term “tax-advantaged” includes the ability to defer the taxation of income by making an elective deferral, the tax-deferred growth of account assets, or the tax-free withdrawals available to plan participants. Types of tax-advantaged retirement arrangements available under the IRC include traditional Individual Retirement Accounts (IRAs), Roth IRAs, rollover IRAs, SIMPLE IRAs, 401(k) plans, profit-sharing plans, employee stock ownership plans, money purchase plans, defined benefit plans, Simplified Employee Pensions, Salary Reduction Simplified Employee Pension, SIMPLE 401(k) plans for small employers, 403(b) tax-sheltered annuity plans for 501(c)(3) organizations and public schools, and 457(b) deferred compensation plans for state and local governments.

3 See National Taxpayer Advocate 2009 Annual Report to Congress 384-90 (Legislative Recommendation: *Provide a Uniform Definition of a Hardship Withdrawal from Qualified Retirement Plans*); National Taxpayer Advocate 2008 Annual Report to Congress 373-74 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 423-32 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).

4 The federal poverty guidelines are a measure of income level issued annually by the Department of Health and Human Services. See U.S. DEP’T OF HEALTH & HUMAN SERV., 2015 POVERTY GUIDELINES (Sept. 3, 2015), available at <http://aspe.hhs.gov/2015-poverty-guidelines>.

5 See Systemic Advocacy Management System Issue 32816 (submitted Apr. 15, 2015).

6 See Taxpayer Bill of Rights, available at www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

hardship withdrawals are so confusing that they present a trap for the unwary, often leading to unintended consequences that unfairly harm taxpayers who, by definition, are suffering from hardship.

EXAMPLE

Taxpayer A, who is 45 years old, first opened a Roth Individual Retirement Account (IRA) account three years ago and has contributed \$5,000 every year. The taxpayer's Roth IRA balance is \$18,000, of which \$3,000 is attributable to earnings. Taxpayer A currently works full-time for Employer B, a state agency. Taxpayer A participates in Employer B's governmental 457(b) plan and as of October 1, 2015, had \$60,000 in the plan attributable to his elective contributions and contributions made by Employer B. Taxpayer A used to work for Employer C, a company that maintains a 401(k) plan for its employees and made pre-tax contributions to the 401(k) plan while Taxpayer A was employed with Employer C. Taxpayer A's account balance with Employer C's 401(k) plan is \$25,000 as of October 1, 2015.

During 2015, Taxpayer A is faced with a medical emergency that will require surgery and force him to miss six months of work. Because his health insurance will cover only 70 percent of the estimated \$50,000 medical expenses, Taxpayer A will have out-of-pocket costs of \$15,000 for his surgery. Taxpayer A estimates he will need an additional \$20,000 to cover living expenses for his family during the next six months while he is on unpaid leave.

Taxpayer A recalls that some co-workers from Employer C were allowed to make hardship withdrawals from their retirement plans for occasions such as a home purchase. Taxpayer A would like to know whether he can receive a distribution from his Roth IRA or his two employer-based plans to help pay medical and living expenses for the next six months. After spending two weeks reading through plan documents and talking with friends, colleagues, and plan administrators, Taxpayer A arrives at the following conclusions:

- (1) He may withdraw \$15,000 from his Roth IRA (the amount contributed) without any tax consequences. Distributions in excess of the \$15,000 that will be used for medical expenses (to the extent it does not exceed the amount allowable as a deduction under IRC § 213) will not be subject to the ten percent additional tax. Any distribution he uses for living expenses while he is unable to work will be includible in taxable income to the extent the distribution exceeds his contributions to the Roth IRA and subject to the ten percent additional tax.
- (2) His governmental 457(b) plan with Employer B allows in-service distributions for "unforeseeable emergencies." For this purpose, an unforeseeable emergency is a severe financial hardship resulting from an illness or accident. The ten percent additional tax does not apply to distributions from a governmental 457(b) plan.
- (3) His 401(k) plan with Employer C allows in-service distributions on account of hardships. For this purpose, a hardship means an instance of "immediate and heavy financial need" and the plan provides that the regulatory safe harbor rules will be used to determine whether an employee qualifies for the distribution. Medical expenses, but not living expenses, for the period he is unable to work fall under the safe harbor definition of immediate and heavy financial need. Hardship distributions are included in taxable income and subjected to the ten percent additional tax for early withdrawal.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress establish uniform rules regarding the availability and tax consequences of hardship withdrawals from tax-advantaged retirement plans and arrangements. Hardship withdrawals should be permitted when a participant is faced with an unforeseeable emergency or severe financial hardship. Examples of unforeseeable emergency or severe financial hardship may include:

1. Expenses for medical care incurred by the employee, the employee's spouse, or dependents;
2. Payments necessary to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage on that residence;
3. Loss of property due to casualty;
4. Basic living expenses of low income taxpayers (those at or below the 250 percent of the federal poverty guideline); or
5. Financial hardship resulting from an extended period of unemployment.

The National Taxpayer Advocate further recommends that the IRS exempt such hardship distributions from the ten percent additional tax imposed by IRC § 72(t).

PRESENT LAW

Determining the tax treatment of early distributions from certain tax-advantaged retirement arrangements involves a three-pronged analysis. First, we must ascertain whether the distribution is allowed in the first place. If allowed, there must be a determination regarding the taxability of such distribution. Finally, we must determine whether the distribution is subject to the IRC § 72(t) addition to tax.

The following sections discuss the application of this analysis with respect to distributions from various qualified plans.

401(k) Plans

In the absence of a hardship, a 401(k) plan may generally only distribute benefits attributable to elective contributions upon an employee's death, disability, attainment of age 59½, or severance from employment.⁷ Applicable Treasury regulations provide that a distribution is made due to hardship only if (1) the distribution is made due to an immediate and heavy financial need of the employee, and (2) the distribution is necessary to satisfy the immediate and heavy financial need.⁸

Applicable Treasury regulations provide that whether an employee has an immediate and heavy financial need and the amount necessary to meet such need is determined by the plan administrator based on a consideration of all relevant facts and circumstances.⁹ The regulations also provide a safe harbor under which a distribution may be deemed to be on account of an immediate and heavy financial need in the following six circumstances:

1. Expenses for medical care incurred by the employee, spouse, or certain dependents;
2. Costs directly related to the purchase of a principal residence for the employee;

⁷ IRC § 401(k)(2)(B)(i).

⁸ Treas. Reg. § 1.401(k)-1(d)(3)(i).

⁹ Treas. Reg. § 1.401(k)-1(d)(3)(iii) and (iv).

3. Payment of certain tuition, related educational fees, and room and board expenses for the employee, spouse, children, or certain dependents;
4. Payments necessary to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage of that residence;
5. Payments for burial or funeral expenses for the employee's deceased parent, spouse, children, or dependents; or
6. Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under IRC § 165.¹⁰

The regulations also provide that a distribution is deemed necessary to satisfy an immediate and heavy financial need if:

1. The employee has obtained all other currently available distributions and nontaxable loans under the plan and all other plans maintained by the employer; and
2. The employee is prohibited from making elective deferrals to the plan and all other plans maintained by the employer for at least six months following the hardship distribution.¹¹

Hardship withdrawals are generally includible in the participant's gross income in the taxable year in which paid to the participant and are taxed as ordinary income.¹² In addition, hardship withdrawals are subject to the ten percent additional tax imposed under IRC § 72(t) if no exception applies.¹³

457(b) Plans¹⁴

In general, a governmental 457(b) plan (which covers state and local government employees) participant may not receive a distribution until he or she reaches age 70½ or separates from service, whichever is earlier.¹⁵ However, a governmental 457(b) plan may permit an early distribution to a participant faced with an "unforeseeable emergency."¹⁶

The Treasury regulations define unforeseeable emergency as:

1. A severe financial hardship resulting from an illness or accident;
2. Loss of property due to casualty; or
3. Other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.¹⁷

10 Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B).

11 Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E).

12 IRC § 402(a).

13 Exceptions to the ten percent additional tax under § 72(t)(2)(A) include distributions: (1) made on or after the date on which the employee attains age 59½, (2) made to a beneficiary on or after the death of the employee, (3) attributable to the employee's being disabled, (4) part of a series of substantially equal periodic payments, (5) made to an employee after separation from service after attainment of age 55, (6) dividends paid with respect to stock of certain corporations, or (7) made on account of an IRS levy on the qualified plan.

14 While tax-exempt organizations may also maintain 457 plans, we will limit our discussion to governmental 457(b) plans here.

15 IRC § 457(d)(1)(A).

16 IRC § 457(d)(1)(A)(iii). If certain requirements are met, participants in 457(b) plans may be eligible to receive an in-service distribution of \$5,000 or less. IRC § 457(e)(9)(A).

17 Treas. Reg. § 1.457-6(c)(2)(i).

The regulations provide several examples of events that may constitute unforeseeable emergencies, such as the imminent foreclosure of or eviction from a primary residence, the need to pay for medical expenses, or the need to pay for the funeral expenses of a spouse or dependent.¹⁸ However, the regulations specifically note that the purchase of a home or the payment of tuition are not generally unforeseeable emergencies for purposes of this exception.¹⁹

The ten percent additional tax imposed by IRC § 72(t) does not apply to 457(b) plans because a 457(b) plan is not included in the definition of a “qualified retirement plan” under IRC § 4974(c).²⁰

Roth IRAs

In general, a distribution from a Roth IRA is only includable in taxable income if it exceeds the IRA owner’s basis in the IRA and is not a “qualified distribution.”²¹ For this purpose, a qualified distribution includes a distribution that is:

1. Made on or after the date on which the owner attains age 59½;
2. Made to a beneficiary or the estate of the owner on or after the date of the owner’s death;
3. Attributable to the individual’s being disabled; or
4. Made for a first-time home purchase.²²

Distributions from a Roth IRA that are not qualified distributions are generally includable in taxable income to the extent the distribution exceeds the contributions to the Roth IRA and are generally subject to a ten percent tax, in addition to the ordinary income taxes on the distribution.²³ There are several statutory exceptions to the ten percent additional tax under IRC § 72(t) that include distributions that are attributable to death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher education expenses, health insurance expenses of unemployed individuals, or as part of a series of substantially equal periodic payments.²⁴

18 Treas. Reg. § 1.457-6(c)(2)(i).

19 *Id.*

20 IRC § 72(t)(1).

21 See IRC § 408A(d).

22 IRC § 408A(d)(2)(A) and (d)(5).

23 See IRC §§ 408A(d)(1) and 408A(d)(4)(B); IRC § 72(t).

24 IRC § 72(t)(2).

Figure 2.12.1 lists certain hardship withdrawal exceptions to IRC § 72(t).

FIGURE 2.12.1, Certain Exceptions to IRC § 72(t) Ten Percent Additional Tax for Early Distributions

	Exception	Limitations
IRC § 72(t)(2)(A)(iii)	Attributable to the employee being disabled	Medically determinable physical or mental impairment to be of long-continued and indefinite duration
IRC § 72(t)(2)(B)	Medical expenses	Distribution may not exceed amount allowable as a deduction under IRC § 213
IRC § 72(t)(2)(D)	Health insurance premiums for unemployed individuals	Distribution allowable after individual has received unemployment compensation for 12 consecutive weeks
IRC § 72(t)(2)(E)	Higher education expenses	Qualified higher education expenses (e.g., tuition, fees, books, supplies, equipment) of the taxpayer, taxpayer's spouse, or child/grandchild of taxpayer or spouse
IRC § 72(t)(2)(F)	First-time home purchases	No ownership interest in a principal residence during prior two-year period
IRC § 72(t)(2)(G)	Called to active duty	Qualified reservist distribution may be made at any time during the two-year period after the end of an active duty period

Figure 2.12.2 summarizes the early withdrawal provisions of certain tax-advantaged retirement vehicles.

FIGURE 2.12.2, Summary of Early Withdrawal Provisions of Certain Tax-Advantaged Retirement Plans and Arrangements

	401(k)	457(b) Governmental Plans	Roth IRA
Who is eligible?	Employees of all non-governmental employers	Employees and independent contractors of state & local governments	Individuals (subject to income limitations if covered by employer-provided retirement plan)
Hardship withdrawal allowed while employed or before age 59½?	Yes, if distribution is necessary to satisfy “immediate and heavy financial need”	Yes, for “unforeseeable emergency”	Yes
10% additional tax assessed?	Yes	No	Yes, to the extent the distribution exceeds contributions, except in cases of death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher education expenses, health insurance expenses of unemployed individuals, or as part of a series of substantially equal periodic payments

In summary, 401(k) plan participants are able to take an early distribution of their elective deferrals while still employed with the employer maintaining the plan “upon hardship of the employee,”²⁵ but such distributions may be subject to the ten percent additional tax on early distributions if made before age 59½.²⁶ Participants in 457(b) plans are permitted to take an early distribution of their entire benefit for “unforeseeable emergencies,” and those distributions, like all 457(b) distributions, are not subject to the ten percent additional tax.²⁷ IRAs (including Roth IRAs) are not required to limit early distributions to the account beneficiary.²⁸ However, such distributions are subject to the ten percent additional tax, unless an exception applies.²⁹

25 IRC § 401(k)(2)(B)(i)(IV).

26 IRC § 72(t).

27 IRC § 457(d)(1)(A)(iii).

28 IRC §§ 408(d) and 408A(d).

29 IRC § 72(t)(1).

REASONS FOR CHANGE

The rules covering tax-advantaged retirement plans and arrangements are among the most intricate and complex rules of the tax code and associated regulations.³⁰ In particular, the hardship withdrawal provisions for certain tax-advantaged retirement plans and arrangements lack uniformity and may cause confusion among plan participants. By establishing uniform rules regarding the availability and tax consequences of hardship withdrawals from tax-advantaged plans, Congress will reduce complexity and eliminate meaningless distinctions between the types of plans that may be offered by different types of employers.

As noted above, some retirement plans allow participants to receive an early distribution in cases of financial hardship, such as a medical emergency. There is no uniform definition of “hardship” among the various retirement plans that would enable a participant to easily determine when an early withdrawal is allowable. Even if a plan allows for a hardship withdrawal, participants must deal with inconsistent rules for triggering the ten percent additional tax for early withdrawal imposed by IRC § 72(t).

EXPLANATION OF RECOMMENDATIONS

To ensure taxpayers’ *right to a fair and just tax system*, the National Taxpayer Advocate recommends that Congress establish uniform rules regarding the availability of hardship withdrawals from tax-advantaged retirement plans and arrangements. These scenarios are common examples of when a taxpayer faces an unforeseen emergency that would require him or her to tap into funds earmarked for retirement savings:

1. Expenses for medical care incurred by the employee, the employee’s spouse, or dependents;
2. Payments necessary to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage on that residence;
3. Loss of property due to casualty;
4. Basic living expenses of low income taxpayers (those at or below the 250 percent of the federal poverty guidelines); or
5. Financial hardship resulting from an extended period of unemployment.

Admittedly, it will be impossible to identify all possible instances of unforeseen emergencies, and there may be disagreement as to what is “unforeseen.” For example, we are not including educational expenses as an unforeseen emergency that would qualify as a hardship withdrawal. Congress, in its discretion, could authorize withdrawals for other situations. If it does, it should apply the exception uniformly to all tax-advantaged retirement vehicles and exempt the exception from the ten percent additional tax uniformly.

30 Part of this complexity arises because retirement plans fall under the jurisdiction of three federal agencies — the IRS, the Department of Labor, and the Pension Benefit Guaranty Corporation.