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Personal Foul…Roughing The Taxpayer: The IRS' Triple Penalty On Hardship Distributions

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PERSONAL FOUL…ROUGHING THE TAXPAYER: THE IRS' TRIPLE PENALTY ON HARDSHIP DISTRIBUTIONS

Michael Flynn
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ABSTRACT

Everyone knows of someone, a family member, a co-worker, a neighbor or just an acquaintance, who has been adversely affected by the downturn in the economy. For many, this means dipping into retirement accounts to help out others, to fund college tuition, to pay for unexpected medical bills or just to make ends meet. Then the surprise hits. The retirement account funds, filled with money that each participant paid in for reasons just like these, are not readily available. To the extent that they are available, the funds come at a steep price even though the participant is in desperate need of the money. This article examines the IRS' triple penalty for hardship withdrawals from retirement accounts. First, this article describes the basics of a 401(k)/403(b) retirement plan. Next, this article explains the typical process and plan requirements that control the distributions from retirement accounts. This article then chronicles the economic and tax ramifications of a participant who chooses to use his retirement money for other purposes. Finally, this article concludes by commenting on the unfairness and inequity of a retirement plan that penalizes participants who are the most in need and most vulnerable.

TABLE OF CONTENTS

I. PETE'S UNFORTUNATE CIRCUMSTANCES 17
II. TYPES OF RETIREMENT PLANS 19
A. PETE'S RETIREMENT PLAN 20

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1. *Plan Contributions and Limitations* 21
2. *Pete's Retirement Savings and Other Accounts* 22

III. HOW PETE CAN GET TO HIS MONEY 23
A. PLAN LOANS 24
1. *Loan Requirements and Deemed Distributions* 24
a. Example 1: Pete's Loan has a Repayment Term Period of Eight Years 26
b. Example 2: Pete is Allowed to Borrow in Excess of the Maximum Dollar Amount 27
c. Example 3: Pete Fails to Make the Required Payments 27
d. Example 4: Pete Gets Fired 28
2. *Additional Loan Requirements* 28
3. *Pete's Loan Is Not Enough* 29
a. Hardship Withdrawals 29
B. THE "FACTS AND CIRCUMSTANCES" TESTS 31
1. *Immediate and Heavy Financial Need* 31
2. *Necessary to Satisfy the Need* 32
3. *Showing That There Are No "Reasonably Available" Resources* 34
4. *Example: Pete's Plan Uses the "Facts and Circumstances" Tests to Determine Both the Existence of An Immediate and Heavy Financial Need and the Amount Necessary to Satisfy the Need* 34
a. Provision Against Counterproductive Action 35
C. "DEEMED" SAFE HARBOR RULES 36
1. *"Deemed" Immediate and Heavy Financial Need* 37
a. Pete's Total Need ($255,000) 39
b. Pete's Mortgage ($50,000) 39
c. Pete's Wife's Medical Bills ($65,000) 39
Pete's Daughter's Tuition and Room and Board Expenses ($30,000) 39
d. Pete's Daughter's Tuition and Room and Board Expenses ($30,000) 39
e. Pete's Mother's Funeral Expenses ($10,000) 40
f. Pete's Brother's Mortgage ($50,000) 40
g. Pete's Best Friend's Surgery ($50,000) 40
h. Pete's "Deemed" Total Need ($155,000) 41
2. *"Deemed" Necessary to Satisfy the Need* 41
a. Pete's Hardship Withdrawal Will Be "Deemed" Necessary to Satisfy His Need 42

IV. PERSONAL FOUL IRS 42
A. PENALTY ONE: INCOME TAX 43

B. PENALTY TWO: 10% EARLY DISTRIBUTION PENALTY 43
1. *Pete's Wife's Medical Expenses* 45
2. *Pete's Daughter's Tuition and Room and Board Expenses* 46
3. *Calculation and Due Date* 46
a. Applying the Calculation to Pete's Unfortunate Circumstances 47
C. PENALTY THREE: SIX MONTH SUSPENSION 49
V. JUSTIFICATION OR PUNISHMENT? 51
A. PURPOSE OF THE 10% EARLY DISTRIBUTION PENALTY 51
1. *Experts Say that the 10% Early Distribution Penalty is Working* 52
B. PURPOSE OF THE SIX MONTH SUSPENSION 52
1. *Experts Say that the Six Month Suspension Does Not Serve Its Intended Purpose and Recommend that the Provision be Shortened or Eliminated* 54
VI. CONCLUSION 55
A. MORE EXCEPTIONS TO THE 10% EARLY DISTRIBUTION PENALTY SHOULD BE ADOPTED 55
B. THE SIX MONTH SUSPENSION OF CONTRIBUTIONS SHOULD BE REPEALED 59
VII. PETE'S BITTER-SWEET ENDING 59

I. PETE'S UNFORTUNATE CIRCUMSTANCES

For years Pete had not questioned the retirement plan offered to him by his employer. This plan would be Pete's safety net and a wonderful benefit of his employment—or so he thought—until catastrophe struck his family and Pete found out just what his employer-provided retirement was not. Despite the economic downturn over the past few years,[1] Pete and many other skilled and professional workers have opted to maintain their benefit packages with little to no salary

1. On April 23, 2010, the U.S. Bureau of Labor Statistics reported that the nationwide unemployment rate was 9.7% in March 2010, up 8.6% from the year before. *News Release, Mass Layoffs – March 2010,* BUREAU OF LAB. STATS., U.S. DEP'T OF LABOR (Apr. 23, 2010), http://www.bls.gov/news.release/archives/mmls_04232010.pdf. 1,628 mass layoff actions were taken by employers in March, resulting in the separation of 150,864 workers, an increase of 58% from the month before. *Id.* At a minimum, each layoff involved 50 people from a single employer. *Id.*

increase.[2] This decision was always touted by Pete's employer as the smart way to go because his medical insurance and retirement plan had been the "Cadillac" of benefit packages.

At age fifty-eight, Pete's life has changed dramatically over the past two years. Pete's life has become a classic application of Murphy's Law: "anything that can go wrong will go wrong." Two years ago, Pete's wife of over twenty years was diagnosed with an incurable and progressive illness. Although some of the medical treatments were covered under Pete's employer-provided health plan, most of the treatments were not. The good news is that the medical treatments received by Pete's wife have stabilized and even miraculously reversed her illness, but at the cost of $65,000 in uncovered and unreimbursed medical treatment.

In addition, Pete's best friend was recently diagnosed with a terminal illness. He is not expected to live through the year, but there is some hope. An experimental surgery that is only being performed in Switzerland may be able to save his life. Pete's best friend and his family are able to cover the majority of the cost, but they are $50,000 short.

To make this awful situation even worse, Pete's brother lost his job eleven months ago and has not been able to find work despite actively hunting for a job. Pete's brother's house is currently in foreclosure and about to be sold. If the foreclosure goes through, his brother's family of four will have nowhere to live. The cost to reinstate and modify his brother's existing mortgage loan is $50,000.

Unfortunately, last month Pete found himself in the same situation. Although Pete is still employed, he has not been able to make a mortgage payment in several months. Because Pete has an adjustable rate mortgage, his monthly payments have been going up at an alarming rate. Refinancing is not an option. Thus, Pete's home is also in foreclosure and he needs $50,000 to reinstate his mortgage.

Adding insult to injury, Pete now has an intimate understanding of the high cost of a college education. Despite consistently saving money since the time of his daughter's birth, Pete is caught with rising college

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2. On April 2, 2010, the U.S. Bureau of Labor Statistics reported that average wages have essentially remained flat. *See News Release, The Employment Situation – March 2010,* BUREAU OF LAB. STATS., U.S. DEP'T OF LABOR (Apr. 2, 2010), http://www.bls.gov/news.release/archives/empsit_04022010.pdf.

tuition costs and could use an additional $30,000 to help defray the cost of her education.

And finally, just when Pete thought things could not get any worse, Pete's mother died yesterday. Leaving the family nothing, Pete is the only one who can possibly provide her with a proper burial.

After working through all of the reasonable alternatives available to him, Pete looked at his healthy retirement account balance and inquired as to how he might use the money in his retirement plan to help pay for his wife's medical bills, save his house, keep his brother's family from becoming homeless, save his best friend's life, make sure his daughter can stay in college, and bury his mother. Pete's situation is the topic of this article.

First, this article will describe the basics of a 401(k) and 403(b) retirement plan. Next, this article will describe the typical process and plan requirements that control the distributions from retirement accounts. This article will then chronicle the economic and tax ramifications for a participant who chooses to use his retirement money for other purposes. Finally, this article will conclude by commenting on the unfairness and inequity of retirement plans that actually penalize participants who are the most in need and most vulnerable.

II. Types of Retirement Plans

Nearly one-half of all American workers participate in some type of employer-sponsored retirement plan.[3] These plans are called, "qualified retirement plans."[4] Although employers are not required to offer retirement plans,[5] most employers offer one of two different types of plans: 1) defined benefit plan ("DBP"); or 2) defined compensation plan ("DCP").[6] The differences between the two are simple. Typically, a

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3. In 2006, the most recent year for which data is available, there were over 70 million participants in 401(k) plans with assets totaling over $3 trillion. *See The U.S. Retirement Market, 2007,* INV. CO. INST. (July 2008), http://www.ici.org/pdf/fm-v17n3.pdf.

4. I.R.C. § 4974(c) (2006).

5. *What You Should Know About Your Retirement Plan,* U.S. DEP'T OF LABOR, (2006), http://www.dol.gov/ebsa/pdf/wyskgreenbook.pdf [hereinafter *DOL Booklet*].

6. *Id.* Employers can choose to offer a combination of both, or offer no plan at all. *Id.*

DBP is exclusively funded by employers[7] and participants do not have individual accounts.[8] Plan officials manage and control the investments and are responsible for ensuring that the plan is able to satisfy promised benefits when they become due.[9] Regardless of how these investments perform, DBPs guarantee a fixed level of income for participants at retirement.[10] In contrast, DCP participants have individual accounts, to which the employer, employee, or both make contributions.[11] The responsibility of managing and funding the plan falls upon the participant.[12] At retirement, a DCP will provide a level of income which is ultimately a function of the performance of the investments within the participant's account, and the amount of contributions made to the plan over the course of the participant's career.[13]

A. PETE'S RETIREMENT PLAN

Pete has worked for his employer for thirty-three years. After completing his first year of service, Pete was offered the opportunity to enroll in a retirement plan.[14] Pete's employer offered him a DCP type plan called a 403(b) plan. Being the responsible twenty-five year-old that Pete was, and taking into consideration his new wife and the family they planned on having together, he promptly enrolled in the plan. 403(b) plans are named after Section 403(b) of the Internal Revenue

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7. To ensure that DBPs are able to pay benefits when they become due, federal regulations have set amounts that employers must contribute. *Id.* at 4.

8. *See* 29 U.S.C. § 1002(35) (2006).

9. Unlike a DCP, certain retirement benefits under a DBP are insured by the Federal Government through the Pension Benefit Guarantee Corporation if and when a DBP becomes insolvent. *See Your Guaranteed Pension*, PBGC.COM, http://www.pbgc.gov/wr/benefits/guaranteed-benefits/your-guaranteed-pension.html (last visited October 29, 2011). The PBGC is a federal corporation created by the Employee Retirement Income Security Act of 1974. *Id.* It currently protects the pensions of more than 44 million American workers and retirees in more than 29,000 private single-employer and multiemployer defined benefit pension plans. *Id.*

10. *See* 29 U.S.C. § 1002(35) (2006). The level of income is typically paid on a monthly basis and is derived from the participant's salary and years of service at retirement. *See id.*

11. *See id*. § 1002(34).

12. *DOL Booklet*, *supra* note 5, at 3.

13. *See id.* Unlike a DBP, the Federal Government does not guarantee benefits. *Id.*

14. An employee cannot open a 401(k)/403(b) account himself, his employer must initiate the process. *See id.*

Code (IRC), and are available only to employees who work for nonprofit organizations.[15] For the purposes of this article, Pete's 403(b) plan can be directly analogized to its for-profit counterpart, the 401(k) plan.[16] Pete's plan provides three main benefits: 1) Pete does not have to pay income tax on allowable contributions to his account until he makes a withdrawal, typically after retirement; 2) Pete's account is allowed to grow tax free; and 3) under certain circumstances, Pete will be eligible for a tax credit on his contributions to his account.[17]

1. Plan Contributions and Limitations

Both Pete and his employer are allowed to make pre-tax contributions to his account. Pursuant to a salary reduction agreement, every week since Pete has enrolled, he has had 10% of his paycheck withheld and deposited into his 403(b) account. These deferred wages are typically referred to as elective deferrals, and are not subject to

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15. 403(b) plans are retirement savings plans available to employees who work for 501(c)(3) nonprofit organizations, including public schools, cooperative hospitals, and certain ministers. I.R.C. § 403(b) (2006).

16. *See* I.R.C. § 72(p); I.R.C. § 402(g); Treas. Reg. § 1.403(b)-6(d)(2) (2009) ("A hardship distribution under this paragraph (d) has the same meaning as a distribution on account of hardship under § 1.401(k)-1(d)(3) and is subject to the rules and restrictions set forth in § 1.401(k)-1(d)(3) (including limiting the amount of a distribution in the case of hardship to the amount necessary to satisfy the hardship).").

17. *Tax Sheltered Annuity Plans (403(b) Plans), Publication 571 (12/2010)*, I.R.S.GOV, ch. 1, http://www.irs.gov/publications/p571/index.html (last visited Oct. 31, 2011) [hereinafter *IRS Publication 571*]. A participant, however, cannot make contributions to his 403(b) account directly and still receive the tax benefits. *See id.* These benefits can only be realized through: 1) elective deferrals (money withheld from his pay check); and 2) non-elective contributions (contributions made by his employer). *Id.* Of course, Pete still may choose to make after-tax contributions, but his money will have already been subject to income tax, and is not income tax deductable. *See id.* Moreover, a participant may only claim the tax credit mentioned in benefit 3 above, if four requirements are met: 1) the participant is over the age of 18; 2) the participant in not a full-time student; 3) no one other than the participant claims the tax credit on their tax return, e.g., a participant's parents; and 4) the participant's gross income is no more than: a) $55,500 if the participant is married and filing jointly; b) $41,625 if the participant files as head of the household; or c) $27,750 if the participant is filing as single, is married and filing separately, or a qualified widower with a dependent child. *Id.* at ch. 10. As we will see, unfortunately Pete does not qualify for this tax credit because he makes $75,000 per year.

income tax at the time of deferral.[18] Lucky for Pete, his employer has always matched his contributions. These matching contributions are commonly referred to as non-elective employer contributions.[19] Contributions to Pete's account, however, are limited. Under current regulations, his age (Pete is over 50 years old) and fifteen years of service at a nonprofit organization, allow him to contribute no more than $25,000 per year in elective deferrals to his account.[20] The total annual contribution to Pete's account, including his employer's contributions, must be the lesser of $49,000 and 100% of his salary.[21] If these limits are exceeded, the amount in excess will be included in Pete's gross income for the calendar year.[22]

2. *Pete's Retirement Savings and Other Accounts*

With little effort, Pete has managed to stay within these limits. And over the years, he has managed to accumulate over $540,000 in retirement savings.[23] Approximately $245,000 of that amount can be

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18. *Topic 424-401(k) Plans*, *Publication 571 (12/2010),* I.R.S.GOV, http://www.irs.gov/publications/p571/index.html (last visited Oct. 31, 2011). Elective deferrals are not included as taxable wages on one's W-2, and thus are also not reflected on one's 1040 Form. *Id.* But, elective deferrals are included as wages subject to social security, federal unemployment taxes, and Medicare. *Id.*

19. Employers are not required, but are permitted to make matching or discretionary contributions to their employees' 403(b) accounts. *DOL Booklet*, *supra* note 5, at 4, tbl. 1.

20. *See* I.R.C. § 402(g)(1), (7)(a) (2006). Under I.R.C. § 402(g)(7)(a), Pete's elective contribution limit is increased from the $16,500 limit found in I.R.C. § 402(g)(1) to $19,500, because he has completed 15 years of service with a non-profit organization. *Id.* Pete's limit is further increased by an additional $5,500 by I.R.C. § 414(v), which was added to the I.R.C. by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38 (2001). Under this section, Pete is allowed to make additional "catch-up contributions" because he is over the age of 50. I.R.C. § 414(v). For those participants under the age of 50 who have not completed 15 years at a non-profit organization, the limit on elective deferrals is $16,500. I.R.C. § 402(g). In 2011 and beyond, these caps will increase in $500 increments indexed for inflation. *Id*.

21. I.R.C. § 415(c)(1)(A), (c)(1)(B). In 2011 and beyond, the current cap on total annual contribution will increase just like the cap on elective deferrals, but in increments of $1,000 indexed for inflation. *See* I.R.C. § 402(g)(1), (7)(a).

22. I.R.C. § 402(g).

23. This computation is for hypothetical purposes only and was done using a modest rate of return.

attributed to Pete's elective deferrals. Before his wife's illness, Pete had over $15,000 in his savings account, and $25,000 in his daughter's college fund. But now that college fund is gone, and his savings have dwindled down to $5,000.

Like his father, Pete always planned on retiring at 65. But today those plans have become nothing but a pipe dream. Today, Pete opens his mail box only to find several letters from State Hospital stamped, "FINAL NOTICE." Immediately beneath these envelopes is an overdue tuition bill from State College. As Pete walks through his front door, he gets another desperate call from his brother, followed by a call from his best friend's wife, and yet another from his mortgage company. After arguing and pleading with the mortgage company for hours, his wife comes into the room and hands him the funeral home's $10,000 estimate. It has become obvious to Pete that the only way he can possibly get out of this nightmare is to tap into his retirement fund. He realizes his future is at stake, but this is his only hope.

III. HOW PETE CAN GET TO HIS MONEY

Pete will soon find out that he will not be able to get to his money as easily as he thought. In an effort to ensure that favorable tax treatment is truly limited only to those funds that will be used for retirement, the federal government has placed numerous restrictions on participant access to 401(k)/403(b) retirement funds. In general, a participant is permitted access to their retirement account, without penalty, only if the participant: 1) has reached the age of 59 ½; 2) becomes disabled; or 3) dies.[24] Only under a very limited set of circumstances are plan sponsors permitted to grant access to retirement funds before the occurrence of one of these events.[25]

Within federal guidelines, plan sponsors have broad discretion in deciding whether to provide access to funds before retirement. In fact, plans are not required to offer participants any access at all.[26] Realizing, however, that many employees would not participate at all without some kind of access to their money, today most plans include provisions for

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24. I.R.C. § 72(t)(2).

25. *See infra* Part IV.B.

26. *Retirement Plans FAQs Regarding Hardship Distributions*, I.R.S.GOV, http://www.irs.gov/retirement/article/0,,id=162416,00.html (last visited Nov. 17, 2010).

plan loans and early withdrawals in times of "hardship."[27] Fortunately for Pete, his plan includes both of these provisions.

A. PLAN LOANS

Under current federal regulations, Pete will not be able to take from his retirement savings without first exhausting his plan's loan provisions.[28] Unlike hardship withdrawals, which will be discussed in detail later in this article,[29] plan loans are ultimately paid back to the plan with interest.[30] As compared to other forms of "leakage,"[31] such as cash-outs[32] and hardship withdrawals, plan loans have been found to have the least overall damaging effect on retirement savings.[33]

1. Loan Requirements and Deemed Distributions

Plan loans can be used for any purpose.[34] Yet, plans may restrict loans to certain events, such as acquiring a new home or hardship, as long as these restrictions are not discriminatorily favoring highly compensated participants.[35] The general rule is that plan loans are treated as taxable distributions, and thus are subject to federal income tax.[36] However, an exception exists where the loan meets the requirements set forth in section 72(p) of the Internal Revenue Code.[37] If

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27. *See id.*
28. Treas. Reg. § 1.401(k)-1(d)(iv) (2009).
29. *See infra* Part III.B.
30. *See* I.R.C. § 72(p) (2006).
31. Leakage is a term used by experts in the field to refer to the act of "participants tapping into their accrued retirement savings prior to retirement." *Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings,* U.S. GOV'T ACCOUNTABILITY OFFICE, 2 (August 2009), http://www.gao.gov/new.items/d09715.pdf [hereinafter *GAO REPORT*]. Plan loans are considered leakage only when the participant fails to pay the loan back into the plan. *Id.* at 20.
32. Cash-outs are lump-sum distributions participants may elect to take upon severance from employment which are not required to be paid back into the plan. *See id.* at 9, tbl. 2.
33. *Id.* at 20.
34. DOL Reg. § 2550.408b-1(b) and (c) (2009).
35. *Id.*
36. I.R.C. § 72(p)(1)(A) (2006).
37. I.R.C. § 72(p)(2); *see also* Treas. Reg. § 1.72(p)-1, Q&A 1 (2006). Any attempt to assign or pledge an interest in a plan is also subject to the requirements under the I.R.C. § 72(p)(5); Treas. Reg. § 1.72(p)-1, Q&A 1(a).

the loan does not strictly adhere to these requirements, the entire amount of the loan, or at least part of it, will be treated as an early taxable distribution, and may also be subject to a 10% early distribution penalty.[38]

The threshold requirement is that plan loans must be authorized within the terms of the plan itself, or within a separate agreement later incorporated into the plan.[39] If this is the case, for the exception to apply, the plan loan must meet at least four requirements:

1. the loan must be evidenced by a written, legally enforceable agreement;[40]
2. the loan amount must be the lesser of 50% of the present value of the participant's vested account balance and $50,000, taking into account other outstanding plan loans as well as the present value of the benefits earned by the recipient;[41]
3. the loan must be repaid in substantially equal installments, "not less frequently than quarterly";[42] and
4. the loan must be repaid within five years.[43]

Plan administrators are under an affirmative duty to report loans that are not in compliance with these requirements. If the plan loans fail to meet one of these requirements, such failure will produce one of two possible consequences, depending on what requirement the plan fails to meet: 1) the entire amount of the loan will be considered a "deemed

38. *See* I.R.C. § 72(p)(1)(A), (t)(1). In addition to these costs, some plans require participant's to pay a loan origination fee and/or periodic loan maintenance fees over the course of the loan. *GAO Report*, *supra* note 31, at 16.

39. DOL Reg. § 2550.408b-1(d).

40. Treas. Reg. § 1.72(p)-1, Q&A 3(b) (2006). The writing may be in an electronic form. *Id.* If the agreement is enforceable under the applicable law, the agreement is enforceable without a signature. *Id.* It is also required that the loan agreement specify the amount of the loan, the term, and the repayment schedule. *Id.*

41. I.R.C. § 72(p)(2)(A)(i). A plan loan up to $10,000 is allowed, however, even if it is more than half the participant's vested account balance. *Id.*

42. I.R.C. § 72(p)(2)(C). This requirement will not apply, however, to a period when the employee is on a leave of absence without pay for up to one year. Treas. Reg. § 1.72(p)-1, Q&A 9(a) (2006).

43. I.R.C. § 72(p)(2)(B). A loan will not be treated as a distribution if it extends beyond normal retirement age. ABA JOINT COMM. ON EMP. BENEFITS, IRS QUESTIONS AND ANSWERS, May 13, 1994, Q&A 2 at 1. In addition, this five year requirement is extended to 30 years, if the loan is used for the purchase of the participant's principal residence. I.R.C. § 72(p)(2)(B).

distribution;"[44] or 2) the amount left to be repaid on the loan or the amount of loan offered in excess of the maximum dollar limitation will become a deemed distribution.[45] For example, if there is no enforceable agreement for the loan, or if the loan exceeds a five year term, the entire amount of the loan, from day one, will be considered a deemed distribution.[46] In contrast, if the loan amount exceeds the maximum dollar limitation, or if a participant defaults or misses a payment on the loan, only the amount in excess of the limitation or the outstanding balance is considered a deemed distribution.[47] A plan may, however, offer a grace or "cure" period.[48] And if such a cure period is offered, the deemed distribution will be considered to have occurred on the last day of the cure period.[49] Moreover, if a participant decides to leave his job, or gets fired with a plan loan outstanding, the participant will likely be required to pay the entire balance of the loan within 60 days.[50] If the participant cannot pay off the balance, such will become a deemed distribution.[51] To further illustrate these different outcomes, we will use our friend Pete as an example.

a. Example 1: Pete's Loan has a Repayment Term Period of Eight Years

Assume Pete's $540,000 account has become fully vested. Pete borrows $50,000 to be repaid in equal monthly installments over the next eight years.[52] Here, because the loan by its own terms exceeds the

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44. Interest that accrues on a defaulted loan after it has been treated as a deemed distribution is not taxable to the individual. Chapman v. Comm'r, 73 T.C.M. (CCH) 2405 (1997).

45. Treas. Reg. § 1.72(p)-1, Q&A 4 (2006).

46. *See id.*

47. *See id; see also* Treas. Reg. § 1.72(p)-1, Q&As 4(a), 4(b)(Ex. 4).

48. Treas. Reg. § 1.72(p)-1, Q&A 10(a). The cure period, however, cannot extend beyond the last day of the quarter following the quarter in which payment was originally due. *Id.*

49. *Id.*

50. *GAO Report*, *supra* note 31, at 22; *401k Plan Loans - An Overview*, 401KHELPCENTER.COM, http://www.401khelpcenter.com/loans.html (last visited April 19, 2010).

51. *GAO Report*, *supra* note 31, at 22.

52. The effective date of the loan will start the five year period. *See* ABA JOINT COMM. ON EMP. BENEFITS, IRS QUESTIONS AND ANSWERS, May 7, 2004, Q&A 4.

maximum five year period according to the date the loan was made, Pete will have a deemed distribution of $50,000, the entire loan amount, even if Pete had managed to repay the loan within five years. As a deemed distribution, Pete must pay income tax on the entire $50,000, plus an additional 10% early distribution penalty on that amount, because Pete has not yet reached 59 1/2, died, or become disabled.[53]

b. Example 2: Pete is Allowed to Borrow in Excess of the Maximum Dollar Amount

Pete receives a loan of $75,000. This loan is payable in equal monthly installments over the next five years. At the time of the loan, Pete does not have any other outstanding plan loans. According to section 72(p) of the Internal Revenue Code, Pete's limitation is the lesser of $50,000 and $270,000 (50% of $540,000). Here, Pete's loan exceeds the maximum amount. Accordingly, $25,000 will be considered a deemed distribution, which is the excess of $75,000, the loan amount, over $50,000, Pete's maximum allowable loan amount.[54] Again, just as in Example 1, Pete must pay income tax on the deemed distribution ($25,000), plus an additional 10% early distribution penalty.

c. Example 3: Pete Fails to Make the Required Payments

Pete borrows $50,000 from his account on August 1, 2008. The loan is payable in equal monthly installments due at the end of each month, over the next five years. The loan has an interest rate of 8.75%. Up until July 2009, Pete has been able to make all of the monthly payments. Pete, however, fails to make a payment the following month. Pete's plan allows for a cure period of three months. Thus, Pete has until November 31, 2009 to make up his missed payment from August 1, 2009. Unfortunately, Pete is unable to make any payments. Thus, as of November 31st, the last day of the cure period, Pete will have a deemed distribution. The deemed distribution is the outstanding balance on the loan as of November 31st.[55] Yet again, Pete must pay income tax on the

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According to the IRS, the date the check is delivered to participant is the date on which the five year period will begin. *Id.*

53. Treas. Reg. § 1.72(p)-1, Q&A 4(b), ex. 3. *See also* Campbell v. Comm'r, T.C.M. (CCH) 2001.

54. Treas. Reg. § 1.72(p)-1, Q&A 4(b), ex. 1 (2006).

55. Treas. Reg. § 1.72(p)-1, Q&A 10(c), ex. 1.

deemed distribution, plus a 10% early distribution penalty based on that amount.

d. Example 4: Pete Gets Fired

On August 1, 2008, Pete borrows $50,000 from his account. The loan satisfies all of the requirements set forth under section 72(p) of the Internal Revenue Code. Pete has not missed a payment in two years. On August 1, 2010, Pete gets fired. Not only has Pete lost his job, but now, under the terms of Pete's plan, the entire balance of loan is due within 60 days. Pete has been saving everything that he can, but it is impossible for him to pay off the balance. Once again, since Pete cannot come up with the money, the remaining balance becomes a deemed distribution, subject to income tax, plus a 10% early distribution penalty. The fact that the distribution is involuntary will not preclude the imposition of the 10% early distribution penalty.[56]

2. *Additional Loan Requirements*

In addition to all of the requirements set forth in section 72(p) of the Internal Revenue Code, plan loans: 1) must charge a reasonable rate of interest[57] and be adequately secured[58]; 2) must be available to all participants and beneficiaries on a reasonably equivalent basis;[59] and 3) must not be issued in a discriminatory manner in favor of highly

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56. *In re* Kochell, 804 F.2d 84 (7th Cir. 1986) (holding the 10% early distribution penalty applied where bankruptcy trustee withdrew funds from participant's IRA to pay off creditors); *see also* Vorwald v. Comm'r, T.C.M. (CCH) 1697 (1997) (holding the 10% early distribution penalty applied where distribution resulted from a garnishment proceeding by the participant's ex-wife that the participant was completely unaware of). *Id.*

57. In its examples, the IRS uses an interest rate of 8.5% compounded annually. *See* Treas. Reg. § 1.72(p)-1. Yet, a variable interest rate may also be permitted. *See* STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GEN. EXPLANATION OF THE TAX REFORM ACT OF 1986 728 (Comm. Print 1987).

58. ERISA § 408(b)(1). Most plans require that the loan be secured by the participant's vested account balance. *See* I.R.C. § 417(a)(4) (2006); Treas. Reg. § 1.401(a)-20, Q&A 24 (2006). Some plans require that the participant obtain his or her spouse's consent to use the vested balance as collateral within 90 days of using the account balance as collateral. *Id.*

59. ERISA § 408(b)(1).

compensated employees.[60] If loans are found to be "shams," the plan in question could be disqualified in its entirety.[61]

3. Pete's Loan Is Not Enough

After contacting his plan administrator, and signing all of the necessary paper work, Pete was able to secure a plan loan for $50,000. The loan is to be repaid in equal monthly installments over the next five years with an interest rate of 8.75%. So far, Pete's plan loan is in compliance with all of the requirements set forth in section 72(p) of the Internal Revenue Code. As long as Pete does not miss a payment or get fired, his loan will not be treated as a "deemed distribution," and thus he will incur no tax liability on the loan. But, as we know, this $50,000 is not going to be enough. It does not come close to covering his wife's medical bills. Pete still has to come up with $50,000 to save his house, another $50,000 to save his brother's house, $30,000 to keep his daughter in college, another $50,000 to have a chance at saving his best friend's life, and $10,000 to give his mother a proper burial.

With all of this in mind, Pete talks with his plan administrator about what else can be done. The administrator tells Pete that, given his unfortunate circumstances, he may be eligible to take a hardship withdrawal which should cover almost all of his expenses. Initially, Pete is relieved. But upon further explanation, Pete is disheartened when his administrator explains the tax implications associated with taking the hardship withdrawal. Pete's future is at stake, but he knows this is his only choice.

a. Hardship Withdrawals

In an effort to ease participants' concerns in the event of a financial emergency like Pete's, Congress has drafted provisions which permit participants access to their 401(k)/403(b) accounts through "hardship withdrawals."[62] Yet, like loans, plans are not required to provide for hardship withdrawals.[63] And plans that do offer hardship withdrawals

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60. *Id.*

61. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 9701001 (Jan. 3, 1997) (holding plan loans resulted in plan disqualification); I.R.S. Priv. Ltr. Rul. 9713002 (Mar. 28, 1997); I.R.S. Priv. Ltr. Rul. 9724001 (June 13, 1997).

62. I.R.C. § 401(k)(2)(B)(i)(IV) (2006).

63. *See id.*

may, at any time, be amended or dropped altogether.[64] Unlike loans, hardship withdrawals cannot be repaid, and thus permanently reduce the participant's account balance.[65] Typically, hardship withdrawals may not exceed an amount equal to the participant's elective deferrals as of the date of the hardship withdrawal, reduced by the amount previously distributed under other hardship withdrawals, if any.[66]

If a plan provides for hardship withdrawals, it may do so only if the distribution is made on the account of an "immediate and heavy financial need" *and* the distribution is "necessary" to satisfy that need.[67] The need of the participant includes the need of the participant's spouse and dependents,[68] as well as non-spouse and non-dependent beneficiaries under the plan.[69] The terms of the plan must establish nondiscriminatory and objective standards for determining whether these conditions exist.[70] Plans may choose to utilize: 1) the general "facts and circumstances" tests provided in the IRS regulations; 2) the "deemed" hardship safe harbor rules also provided within the IRS

64. Treas. Reg. §1.411(d)-4, Q&A 2(b)(2)(x) (2007). Generally, the anti-cutback rules of I.R.C. § 411(d)(6) prohibit plans from reducing or eliminating certain forms or types of benefits, such as the timing of plan distributions. Nonetheless, this special rule permits the amendment of plans to reduce or even drop its hardship withdrawal provisions all together without violating the anti-cutback rules. Treas. Reg. §1.411(d)-4, Q&A 2(b)(2)(x).

65. *See* ABA JOINT COMM. ON EMP. BENEFITS, IRS QUESTIONS AND ANSWERS, May 11, 2002, at 1. The IRS's position is that the only way a participant can repay a hardship withdrawal is to rollover such back into plan. After 2002, a hardship distribution cannot be rolled over. So, repayment is no longer possible. *Id.*

66. Treas. Reg. §§ 1.401(k)-1(d)(2)(ii), 1.401(k)-1(d)(3)(ii) (2009). A plan may choose, however, to increase this amount by: 1) earned income attributable to the participant's elective contributions; 2) other amounts treated as elective contribution under the regulations ("qualified matching contributions" and "qualified non-elective contributions" defined in Treas. Reg. §§ 1.401(k)-1(g)(13) and Treas. Reg. § 1.401(k)-6)); and 3) earned income attributable to amounts treated as elective contributions. Treas. Reg. § 1.401(k)-1(d)(2)(ii). Only amounts credited to the participant's account before the end of the last plan year ending before July 1, 1989, are eligible. *Id.*

67. Treas. Reg. § 1.401(k)-1(d)(2)(i).

68. *Id*. § 1.401(k)-1(d)(3)(i).

69. *See* Pension Protection Act of 2006, Pub. L. No. 109-280 § 826, 120 Stat. 780, 999 (2006), which required the Secretary of the Treasury to issue regulations expanding the definition of hardship to include the hardship of non-spouse and non-dependent beneficiaries.

70. *See id.*; *see also* Treas. Reg. § 1.401(k)-1(d)(3)(i) (2009).

regulations; or 3) any combination of the two.[71] Failure to comply with one of these tests, however, may disqualify the plan entirely.[72]

B. THE "FACTS AND CIRCUMSTANCES" TESTS

1. *Immediate and Heavy Financial Need*

Treasury Regulation section 1.401(k)1-(d)(3)(iii) sets out a basic and subjective test for determining the existence of an immediate and heavy financial need: "whether [a participant] has an immediate and heavy financial need is to be determined based on all the relevant *facts and circumstances*."[73] The need may still be considered immediate and heavy even if the circumstances which created the need were "reasonably foreseeable or voluntarily incurred by the [participant]."[74] This particular provision provides no guidance in applying this test, save for the following obvious example:

> [T]he need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need, [whereas], [a] distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need.[75]

As a result, an administrator of a plan adopting the "facts and circumstances" test is likely, although not required, to consult the "deemed" safe harbor rules following this section in making his

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71. *See* Treas. Reg. § 1.401(k)-1(d) (2009).

72. *See* I.R.C. 4974(c) (2006). Moreover, for purposes of administrative convenience, most plans: 1) place a limit on the number of hardship withdrawals that a participant can make during a particular period; 2) will only process withdrawals at the end of a plan quarter; and 3) have an established minimum withdrawal amount. 1 MARTHA PRIDDY PATTERSON, THE 401(K) HANDBOOK ¶ 420 (2010). The majority of plans also allow participants to designate the investment vehicle from which the withdrawal is to be made. *Id.* Although plans may charge an administrative fee for processing withdrawal requests, most plans do not do so. *Id.*

73. Treas. Reg. § 1.401(k)-1(d)(3)(iii) (2009) (emphasis added).

74. *Id. Cf.* I.R.C. § 457(d)(1)(A)(iii) (2006). 457(b) plans, unlike 401(k)/403(b) plans, only permit hardship withdrawals if a participant is faced with an "unforeseeable emergency." *Id.*

75. Treas. Reg. § 1.401(k)-1(d)(3)(iii) (2009)

determination, which provides a list of specific expenses that are "deemed" to constitute immediate and heavy financial need.[76]

2. *Necessary to Satisfy the Need*

Whether a hardship withdrawal is considered "necessary" to satisfy the participant's immediate and heavy financial need, is also determined "on the basis of all the relevant *facts and circumstances*."[77] This particular "facts and circumstances" test, however, is more structured, and is satisfied only if:

1. the withdrawal amount does not exceed the amount of the need;[78] and
2. the need cannot be relieved from other resources which are "reasonably available" to the participant.[79]

The amount required to satisfy the "need" referred to in part one of this test "may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution."[80] For purposes of part two of this test, "the [participant's] resources are deemed to include those assets of the employee's spouse and minor children that are "reasonably available" to the employee."[81] Such assets are not limited to liquid assets, and thus include real and personal property.[82] The regulations offer this example:

> [A] vacation home owned by the employee and the employee's spouse, whether community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. [Yet], property held for the [participant's] child under an irrevocable trust or under the uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the [participant].[83]

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76. *See infra* pp. 37-38.
77. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(B) (emphasis added).
78. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(A).
79. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(B).
80. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(A).
81. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(B).
82. *See id.*
83. *Id.*

What the regulations fail to explain is what exactly is meant by "reasonably available."[84] Under this provision, could Pete's administrator determine that his wife's diamond engagement ring is "reasonably available?" Could he also determine that Pete's daughter's savings bonds that she has collected each birthday since she was five are "reasonably available?" Unfortunately, the answer is probably "yes."[85] All of these assets could be "reasonably" obtained and liquidated. Of course, the bonds may not have matured, and it may take a considerable amount of time to find a buyer who is willing to pay fair market value for the engagement ring. But it could arguably take even longer to find a buyer who is willing to pay fair market value for a "vacation home" in the current economic climate;[86] and in each of the aforementioned scenarios the assets would likely be deemed "reasonably available."

Nevertheless, the regulations seem to at least provide that property held in an irrevocable trust for the benefit of another would not be considered "reasonably available" to the participant.[87] Therefore, if a participant wants to ensure that certain assets are not considered "reasonably available," placing such assets in an irrevocable trust for the benefit of another may be the only way around this particular provision.[88]

In reality, the administrator's interpretation of "reasonably available" only matters if the plan requires an actual investigation into the participant's assets. Alternatively, plan administrators are also permitted under the regulations to rely on the representations of the participant.[89] In such a situation, the participant's interpretation of "reasonably available," is the interpretation that matters most.[90]

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84. *See id.*

85. *See id.*; Treas. Reg. § 1.401(k)-1(d)(6) (stating that a participant's savings account is considered reasonably available).

86. *See* Treas. Reg. § 1.401(k)-1(d)(3)(iv)(B).

87. *See id.* "[P]roperty held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee." *Id.*

88. *See id.*

89. *See* Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C).

90. *See* Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C).

3. Showing That There Are No "Reasonably Available" Resources

Unless the employer has actual knowledge to the contrary, the employer may rely on the employee's representation, in writing,[91] that the need cannot be relieved by:

1. insurance compensation or reimbursement;
2. liquidation of assets "reasonably available" to the participant;
3. the cessation of participant or elective contributions to the plan;
4. other available distributions and nontaxable loans available under the plan or by plans maintained by other employers; or
5. borrowing from commercial sources on "reasonable commercial terms.[92]

Again, it is important to note that a plan may choose to apply just one, both, or none of the "facts and circumstances" tests.[93] Nevertheless, in order to illustrate how these tests apply in a practical situation, we will use our friend Pete as an example and assume that his plan adopts both "facts and circumstances" tests.

4. Example: Pete's Plan Uses the "Facts and Circumstances" Tests to Determine Both the Existence of an Immediate and Heavy Financial Need and the Amount Necessary to Satisfy the Need

Assume Pete has already obtained a plan loan for $50,000, the maximum distributable amount under current regulations. Pete's plan provides for hardship distributions on account of "immediate and heavy financial need." Also, assume that Pete's plan uses the "facts and circumstances" tests to determine both the existence of the immediate and heavy financial need and the amount necessary to satisfy the need. Pete has not yet received a hardship distribution from his plan, and the total amount of elective deferrals made by Pete is $245,000. Pete requests a $30,000 hardship withdrawal to pay for a semester of his daughter's tuition and room and board expenses at State College. Fortunately, Pete's plan does not require an actual investigation into the

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91. *Id.* The Commission may later prescribe other forms. *Id.*
92. *Id*.
93. *See id.* § 1.401(k)-1(d).

assets of its participants.[94] Pete makes a representation in writing that his need cannot be satisfied by: 1) insurance; 2) cessation of elective contributions; 3) plan loans; and 4) commercial loans. Still, being the honest man that Pete is, he discloses that he has a savings account with a balance of $5,000.

According to Pete's plan, the *existence* of immediate and heavy financial need is to be determined based on the relevant facts and circumstances. Under this test, Pete's daughter's tuition is likely to be considered such a need. Under the "deemed" safe harbor rules, distribution for payment for up to the next twelve months of post-secondary education, as well as room and board expenses for a participant's dependent, is "deemed" to be on account of an immediate and heavy financial need.[95]

Moreover, according to the plan, a distribution is *necessary* to satisfy Pete's need only to the extent that the need may not be satisfied from other resources "reasonably available" to Pete. Although the plan does not require an actual investigation into Pete's assets, Pete's $5,000 in savings that he chose to disclose is a resource that clearly is "reasonably available" to him and will be taken into account in determining the amount *necessary* to satisfy the need. Thus, even though Pete requested a $30,000 hardship withdrawal, Pete may only receive a distribution of $25,000.[96]

a. Provision Against Counterproductive Action

The rules go on to state that the participant "need not take counterproductive action."[97] Upon reading this title of the provision, a participant is likely to breathe a sigh of relief. In reality, however, the provision provides for less in practice, than its language lets on. According to the rules, an action is considered counterproductive only if the effect of taking such action would increase the participant's need.[98] The rules provide only one example: "the need for funds to purchase a principal residence cannot be reasonably relieved by a plan loan if the

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94. Otherwise, Pete's plan administrator would have the responsibility of making the determination as to what is "reasonably available" to Pete. *See* Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C) (2009).

95. *Id.* § 1.401(k)-1(d)(3)(iii)(B).

96. *See* Treas. Reg. § 1.401(k)-1(d)(6), ex. 3.

97. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C)-(D).

98. *See id.*

loan would disqualify the employee from obtaining other necessary financing."[99] Granted, this example makes perfect sense, but it provides little guidance for what other actions should also be considered "counterproductive."

In the current economic climate, it is likely, if not certain, that if a participant is forced to sell his vacation home, or liquidate any other asset "reasonably available" to him—for example, a car or a boat—the participant is not going to receive anything close to what he originally paid for it.[100] Right now, it is clearly a buyer's market.[101] Should it not then be considered "counterproductive" to be forced to sell one's vacation home, originally purchased for $350,000, for a mere $125,000? Although this loss does not "increase" the amount of the participant's immediate and heavy financial need; it indisputably has some effect on the participant's overall financial standing. Unfortunately, the IRS has yet to provide any further guidance on this issue. As a result, administrators are likely to err on the side of caution and limit this provision to instances tracking the example found in the regulations.

C. "DEEMED" SAFE HARBOR RULES

From here on, we now assume that Pete's plan, like most plans today, has adopted the "deemed" safe harbor rules both for determining the existence of an immediate and heavy financial need, *and* determining whether the distribution is necessary to satisfy the need. Like the "facts and circumstances" tests, plans are not required to adopt these rules. Rather, plans may choose to adopt just one, both, or none of the "deemed" safe harbor rules.[102] Because these rules were issued, and therefore approved by the IRS, certainty in compliance is the obvious benefit realized by adopting these rules, but there are also others.

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99. *Id.*

100. *See, e.g.,* Jenifer B. McKim, *Luxury for Less; Thanks To A Slow Market, Finding Bargains on High-end Homes Is Easy*, BOSTON GLOBE, Apr. 11, 2010, at 6; Shannon Behnken, *The Perils of Pursuing Property: It is Still a Buyer's Market, But Experts Warn That There are Potential Pitfalls to Consider Before You Think About Closing the Deal*, TAMPA TRIBUNE, Mar. 21, 2010, at 1; Dawn Wotapka, *For Some Markets, Bubble-Era Prices Decades Away*, WALL ST. J. ONLINE (Apr. 13, 2010), http://blogs.wsj.com/developments/2010/04/13/for-some-markets-bubble-era-prices-decades-away/.

101. *See id.*

102. *See* Treas. Reg. § 1.401(k)-1(d) (2009).

Administrators benefit because these rules allow them to point a finger at the IRS when a participant is unhappy. Moreover, under these rules, funds are more likely to stay in the plan because strict and literal compliance is required.

1. "Deemed" Immediate and Heavy Financial Need

If a plan chooses to adopt the "deemed" safe harbor rules, a hardship distribution is *deemed* to be on account of an immediate and heavy financial need of the participant, only if the distribution is used to pay for one of these six enumerated expenses:

1. expenses for or necessary to obtain medical care[103] for the participant, the participant's spouse, or dependant;[104]
2. the down payment on the participant's principal residence (excluding mortgage payments);[105]
3. payment of college tuition, including room and board for the participant, and the participant's spouse, children, or dependents (for the next twelve months only);[106]
4. payments to prevent eviction or foreclosure of the participant's principal residence;[107]
5. payments for burial or funeral expenses for the participant's deceased parent, spouse, children or dependents;[108] and

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103. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B) (2009). Medical care, as defined under this provision, must be deductible under I.R.C. § 213(d) (2006). The expenses for such are "determined without regard to whether expenses exceed 7.5% of adjusted gross income." *Id*.

104. Dependents under this section will include lineal decedents, ancestors, brothers, sisters, uncles, aunts, or in laws, *if* the employee provides for over one-half of the dependant's financial support. I.R.C. § 152(a)–(d).

105. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B) (2009). This particular provision extends only to the participant and applies only to the purchase of the principal residence, not improvements, additions, or refinancing. *See* JOINT COMM. ON EMP. BENEFITS, IRS QUESTIONS AND ANSWERS, May 7, 2004, at 29. A participant's buyout of the equity on his or her current home from the participant's ex-spouse is included in the calculation of financial need. *Id.* at 9.

106. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B) (2009). The final regulation issued in 1991, did not contain a provision for "room and board" expenses. Ellin Rosenthal, *IRS Officials Brief Practitioners on Section 401(k), (m) Regs.*, TAX NOTES TODAY, Aug. 28, 1991. IRS representatives publicly stated that the omission of "room and board expenses" was a conscious decision. *Id.*

107. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B) (2009).

6. expenses for repair of damage to the participant's principal residence.[109]

As one can see, these conditions are very specific and leave little room for flexibility. For example, under these rules, if a participant's vacation home is going into foreclosure, it would not be considered an immediate and heavy financial need because it is not their "principal residence."[110] A literal reading of these rules requires that medical expenses must have been already incurred, or needed, in order to obtain medical services.[111] For example, if one has a surgery scheduled, the cost of such would not be sufficiently "immediate" unless the surgeon required some type of down payment "to obtain medical care."[112] In that scenario, one would have to get the surgery, get billed, and then apply for the hardship distribution in order for these circumstances to be "deemed" an immediate and heavy financial need.[113]

Of course, the administrator could make a hardship distribution for an expense which "technically" does not fit within any of these enumerated expenses, but then the distribution would fall outside of the safe harbor. Although the plan would not necessarily be disqualified; the effect of the distribution would be uncertain, giving rise to the same problems the administrator would have faced if the plan had adopted the "facts and circumstances" test. Thus, an administrator is more likely to read the rules literally in order to guarantee that each distribution fits exactly within one of the enumerated expenses.

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108. *Id*. Dependents under this section have the same meaning as dependents in the first enumerated expense. *See id*.

109. *Id.* Treasury Regulation section 1.401(k)-1(d)(3)(v) provides that "[t]he Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin, expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need." Treas. Reg. § 1.401(k)-1(d)(3)(v). The Commissioner has not yet done so. *See* Treas. Reg. § 601.601(d)(2).

110. Whether property is used by a taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. *See* I.R.C. § 121 (2006). If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. *See* I.R.C. § 121 (2006).

111. *See* Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B).

112. *See id.*

113. *See id.*

To further illustrate the operation of these rules, we will apply them to Pete's unfortuante circumstances.

a. Pete's Total Need ($255,000)

Pete's unfortunate circumstances have given rise to a total need of $255,000. Pete's plan has adopted the "deemed" safe harbor rules for determining the existence of an immediate and heavy financial need. Assume Pete has successfully obtained a $50,000 plan loan. Accordingly, Pete requests a $205,000 hardship distribution, which will cover all of his expenses, minus the $50,000 loan.

b. Pete's Mortgage ($50,000)

Pete needs $50,000 to save his house. Under the "deemed" safe harbor rules, a distribution necessary to prevent eviction or foreclosure of Pete's *principal* residence is considered an immediate and heavy financial need. Pete owns no other residence. Thus, Pete's mortgage fits within these rules, and Pete is deemed to have an immediate and heavy financial need of $50,000 for this purpose.[114]

c. Pete's Wife's Medical Bills ($65,000)

Pete also needs $65,000 to pay his wife's medical bills. Under the "deemed" safe harbor rules, expenses for or necessary to obtain medical care for the participant, the participant's spouse, or dependant are deemed to be an immediate and heavy financial need. Since these medical expenses are for his spouse, and have already become due, Pete is deemed to have a need of $65,000 for this purpose.

d. Pete's Daughter's Tuition and Room and Board Expenses ($30,000)

To keep his daughter in college, Pete needs $30,000. Under the "deemed" safe harbor rules, expenses for college tuition for the participant, the participant's spouse, children, or dependents for the next twelve months are deemed to be an immediate and heavy financial

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114. Luckily, Pete has not already used the $50,000 of plan loan money to pay his own mortgage. If he had, Pete would not be "deemed" to have any need for this purpose.

need.[115] Since these expenses are for Pete's child, he is deemed to have an additional need of $30,000.

e. Pete's Mother's Funeral Expenses ($10,000)

In order to give his mother the proper burial and funeral service that she deserves, Pete needs $10,000. Under the "deemed" safe harbor rules, payments for burial or funeral expenses for the participant's deceased parent, spouse, children or dependents are "deemed" to be an immediate and heavy financial need. Since these burial and funeral expenses are for Pete's parent, he is deemed to have an immediate and heavy financial need of $10,000 for this purpose.

f. Pete's Brother's Mortgage ($50,000)

Pete needs another $50,000 to save his brother's house. However, under the "deemed" safe harbor rules, only a distribution necessary to prevent eviction or foreclosure of *Pete's* principal residence would be considered an immediate and heavy financial need. Thus, Pete's brother's mortgage does not fit within these rules, and Pete is not considered to have an immediate and heavy financial need for this purpose. Thus, if Pete is going to save his brother's house, he will have to use the money from his loan, which can be used for any purpose.[116]

g. Pete's Best Friend's Surgery ($50,000)

Pete's best friend needs $50,000 in order to receive what may be life saving surgery. Under the "deemed" safe harbor rules, however, only expenses for or necessary to obtain medical care for the participant, the participant's spouse, or a dependant are deemed to be an immediate and heavy financial need. Because Pete's best friend cannot be considered a dependent,[117] Pete is not considered to have an immediate and heavy financial need for this purpose. Thus, if Pete ever wants to see his best friend again, he will have to use the $50,000 plan loan to pay for the surgery.

115. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(3) (2009).
116. *See* 29 C.F.R. § 2550.408b-1 (2009).
117. Dependents include lineal decedents, ancestors, brothers, sisters, uncles, aunts, or in-laws, only if the employee provides for over one-half of the dependent's financial support. I.R.C. § 152(a)–(d) (2006).

Unfortunately, this is the same $50,000 that Pete has to use in order to save his brother's house. Under the "deemed" safe harbor rules, there is no other way to access Pete's money. Moreover, Pete's plan administrator has refused to make an exception, citing strict compliance. The administrator expressed his concern, blamed the IRS, and told Pete that there was nothing he could do and that Pete would be forced to make a very tough choice.

h. Pete's "Deemed" Total Need ($155,000)

Even though Pete requested $205,000, Pete's total "deemed" immediate and heavy financial need is only $155,000. Thus, Pete may only receive a distribution for $155,000, plus any amounts necessary to pay taxes and penalties.[118] Before this can happen, however, Pete must demonstrate that the amount he requested is "deemed" *necessary* to satisfy that need.

2. "Deemed" Necessary to Satisfy the Need

Under the "deemed" safe harbor rules, a hardship withdrawal is "deemed" necessary to satisfy the immediate and heavy financial need only if:

1. the withdrawal amount does not exceed the amount of the need;
2. the participant has obtained all distributions, and nontaxable loans under the plan; and
3. the participant is prohibited under the terms of the plan from making contributions to the plan for at least six months after the employee receives the hardship distribution.[119]

Here, unlike the "facts and circumstances test," no inquiry into the employee's financial status is required.[120] Thus, a participant can take the hardship withdrawal without first liquidating all assets "reasonably available" to him. [121] The most significant provision of the "deemed"

118. Treas. Reg. § 1.401(k)-1(d)(3)(iv) (2009).
119. *See id.* § 1.401(k)-1(d)(3)(iv)(A), -1(d)(3)(iv)(E),
120. *See id* § 1.401(k)-1(d)(3)(iv).
121. *Id.* In other cases, an employer may generally rely on the employee's representation that she is experiencing an immediate and heavy need that cannot be

safe harbor rule, however, is part 3, which is discussed in detail in Part IV.B of this article.

a. Pete's Hardship Withdrawal Will Be "Deemed" Necessary to Satisfy His Need

Applying the "deemed" safe harbor rules to this situation, Pete's "deemed" need is $155,000 out of the $205,000 hardship withdrawal he requested. As long as Pete's plan distributes no more than $155,000, plus any amounts that can be reasonably anticipated as necessary to pay taxes and penalties, Pete's withdrawal amount will not exceed the amount of his need. Pete has already obtained all available loans under the plan ($50,000 maximum). Under the terms of his plan, after the distribution, Pete's contributions will be suspended for six months. Pete will then be permitted to take a $155,000 hardship withdrawal, plus any amounts that can be reasonably anticipated as necessary to pay taxes and penalties, and Pete is not required to liquidate any assets "reasonably available to him," such as his $5,000 savings account.[122]

IV. PERSONAL FOUL IRS

When Pete receives this hardship distribution, however, he will find that he really is not getting $155,000. In an effort to deter people from jeopardizing their financial future, the IRS imposes a triple penalty on hardship withdrawals in most instances.[123] After these penalties are applied, Pete will end up with less than half of that money. Tens of thousands of dollars worth of Pete's own savings will go to the IRS.

This triple penalty is a personal foul.[124] We know that Pete's taking is not only justified, but he has exhausted all other sources and proved that he has no other choice. In Pete's dire situation, the IRS' triple penalty does absolutely nothing to deter him from accessing his retirement savings for money. In reality, this triple penalty is nothing more than a metaphorical "kick" while Pete is already down.

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relieved by other sources, but cannot rely on such a representation if the employer has knowledge to the contrary. *Id*.

122. *See id.* § 1.401(k)-1(d)(4)(b)

123. *See infra* Part IV.A-C.

124. A personal foul is a "foul in a game (as basketball) involving usually physical contact with or deliberate roughing of an opponent." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 924 (11th ed. 2003).

A. PENALTY ONE: INCOME TAX

Hardship withdrawals are treated as income, and thus are subject to income tax at the participant's marginal tax rate.[125] Pete currently makes $75,000 dollars per year, and files jointly with his wife. Applying the standard deduction of $11,140[126] and personal exemptions applicable to Pete and his wife ($3,650 x 2 = $7,300),[127] Pete's adjusted gross income is $56,300 ($75,000 - $11,140 - $7,300). Since Pete's adjusted gross income is over $16,750, but not over $68,000, it will be taxed at the 15% marginal tax rate.[128] Thus, according to the IRC, Pete's $155,000 hardship withdrawal will also be taxed at this rate.[129]

B. PENALTY TWO: 10% EARLY DISTRIBUTION PENALTY

Generally, hardship withdrawals are subject to a 10% early distribution penalty[130] if they are made before the participant reaches the

125. I.R.C. § 72(p) (2006).

126. The standard deduction amount for married individuals filing joint returns and surviving spouses is $11,140. Rev. Proc. 2009-50, 2009-45 I.R.B. 617, 13, *available at* http://www.irs.gov/pub/irs-drop/rp-09-50.pdf; I.R.C. § 63(c)(2) (2006).

127. Rev. Proc. 2009-50, 2009-45 I.R.B. 617, 16, *available at* http://www.irs.gov/pub/irs-drop/rp-09-50.pdf; I.R.C. § 151(d).

128. Rev. Proc. 2009-50, 2009-45 I.R.B. 617, 7, *available at* http://www.irs.gov/pub/irs-drop/rp-09-50.pdf; I.R.C. § 1(a).

129. I.R.C. § 72(p). However, as discussed in Part IV.B.3.a., once Pete receives the $155,000 hardship withdrawal he will be forced into the 33% marginal tax bracket. *See* Rev. Proc. 2009-50, 2009-45 I.R.B. 617, 8, *available at* http://www.irs.gov/pub/irs-drop/rp-09-50.pdf; I.R.C. § 1(a). Thus, Pete's total income, including his hardship withdrawal, will be taxed at a 33% marginal rate, not 15%. *Id.*

130. Since one exception to the 10% early distribution penalty is that the participant has reached the age of 59½, one plausible inference is that the provision's main objective is to punish or penalize participants for accessing retirement funds for non-retirement purposes. Nevertheless, the IRS has not officially characterized this 10% early distribution penalty as a "penalty," a categorization which has significance in bankruptcy proceedings. Specifically, if the 10% early distribution penalty is considered a penalty tax, it does not have priority in bankruptcy. On the other hand, if the penalty is considered an income tax it will. Moreover, in 1992, the Tenth Circuit held that the 10% early distribution penalty was punitive in nature, and thus it was not entitled to priority status. *In re* Cassidy, 983 F.2d 161, 164 (11th Cir. 1992).

age of 59 ½.[131] There are, however, numerous exceptions. The 10% early distribution penalty will not apply where the distribution is:

1. made to a beneficiary (or to the estate of the participant) on or after the death of the participant;
2. attributable to the participant being disabled;
3. part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the participant or the joint lives (or joint life expectancies) of such participant and his or her designated beneficiary;
4. made to the participant after separation from service after attainment of age 55;
5. dividends paid with respect to stock of a corporation which are described in IRC § 404(k); or
6. made because of a levy under section 6331 on the qualified retirement plan.[132]

In Pete's case, none of the above exceptions currently apply. Nonetheless, Pete is not entirely out of luck. The IRS has carved out even more exceptions that Pete may utilize. In addition to the exceptions listed above, the 10% early distribution penalty will *not* apply to:

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131. I.R.C. § 72(t). Before 2000, hardship withdrawals were eligible for rollover, and thus were subject to a 20% mandatory withholding in addition to the 10% early distribution penalty. I.R.C. § 402(c)(4)(C) (2000), *amended by* Pub. L. No. 107-16, § 636(b)(1) (2001). In 1999, plan sponsors had discretion over whether to treat hardship withdrawals as eligible for rollover. I.R.S. Notice 99-5; 1999-1 C.B. 319. But regardless of the sponsor's decision, a participant still had the ability to rollover the hardship withdrawal as long as the participant did so within 60 days after receiving the distribution. *See* I.R.C. §§ 402(c)(3) (2001), 408(d)(3)(a) (2006). Congress designed this limitation to prevent participants from taking a hardship withdrawal from their 401(k)/403(b) plan, rolling it over into an IRA, and then taking a hardship withdrawal from that IRA, which is available to account holders paying higher education expenses and first time home buyers without the 10% early distribution penalty. I.R.C. 72(t) (2006). *See also* I.R.S. Notice 98-49; 1998-2 C.B. 365, Q&A, (C)(2) (Sept. 21, 1998); Fulcher v. Comm'r, T.C. Summ. Op. 2003-157 (2003) (holding that taxpayer testimony that a home purchase was his first, was enough on its own to invoke exception).

132. I.R.C. § 72(t)(2)(A) (2006). An employee is separated from service when he is no longer an employee for payroll tax purposes. I.R.S. Priv. Ltr. Rul. 87-21-106 (Feb. 27, 1987). Moreover, this additional income tax will not apply to any portion of the distribution that is not taxable. I.R.C. § 72(t). For example, the tax will not apply to the amount of any unrealized appreciation in employer securities distributed to the taxpayer. *See id.*

1. distributions used to pay medical expenses incurred during the taxable year for the participant, participant's spouse, or dependent, which were not compensated by insurance or otherwise, only to the extent that the amount exceeds 7.5% of the participant's gross income;[133]
2. any distribution to an alternate payee pursuant to a qualified domestic relations order;[134]
3. distributions to unemployed individuals for health insurance premiums;[135]
4. distributions from individual retirement plans for higher education expenses for the participant, the participant's spouse, or any child or grandchild of the participant or the participant's spouse;[136]
5. distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions;[137]
6. distributions from retirement plans to individuals called to active duty.[138]

Fortunately, it seems as though Pete has finally caught a break. Two of Pete's expenses, his wife's medical bills and his daughter's college tuition, appear to fit within this list of enumerated exceptions.

1. Pete's Wife's Medical Expenses

Exception 1 listed above will apply to Pete's wife's medical expenses. Its benefit, however, is limited. The exception only applies to the extent that the medical expenses exceed 7.5% of Pete's gross income.[139] Pete's annual gross income is currently $75,000 and 7.5% of $75,000 is $5,625. Therefore, the 10% early distribution penalty will be

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133. *Id*. §§ 72(t)(2)(B), 213(a).

134. *Id*.

135. *Id*.

136. *Id*. §§ 72(t)(2)(E), (7)(A).

137. *Id*. § 72(t)(8)(A). A "qualified first-time homebuyer distribution" is a distribution which is used by a first time home buyer within 120 days of receipt to pay for the principal residence. *Id.* The term "first-time homebuyer" means any individual who has no present ownership in a principal residence and has not had a principal residence within the last two years. *Id.* § 72(t)(8)(D)(i).

138. *Id.* § 72(t)(2)(G)(ii).

139. *Id.* §§ 72(t)(B), 213(a).

accessed on $5,625 of Pete's wife's medical expenses ($562.50). Pete's wife's medical expenses, however, total $65,000 and $65,000 minus $5,625 is $59,375. This total equals the amount in excess of 7.5% of Pete's gross income. Therefore, the exception will apply and the 10% early distribution penalty tax will not be assessed on $59,375 of Pete's wife's medical expenses.

2. Pete's Daughter's Tuition and Room and Board Expenses

At first glance, the fourth exception listed above appears to apply to Pete's daughter's tuition and room and board expenses;[140] however, in reality, it does not. The exception only applies to distributions from "individual retirement plans."[141] Pete has a 403(b) plan. 401(k)/403(b) plans are "qualified plans" under the Internal Revenue Code, not "individual retirement plans."[142] "Individual retirement plans" are limited to IRA's.[143] Consequently, the $30,000 bill Pete received from State College will be subject to the 10% early distribution penalty ($3,000).

3. Calculation and Due Date

The 10% early distribution penalty on hardship withdrawals and other early distributions, such as loan defaults, is an additional income tax. Thus, it adds ten percentage points to the participant's regular income tax rate.[144] The calculation is fairly simple, unless the distribution itself, which is considered income, forces the participant into an entirely different tax bracket.[145] Like all incomes taxes, the 10% early distribution penalty is payable on or before April 15th of the year in which the hardship distribution is received.

Once again, to illustrate, we will use Pete as an example.

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140. *Id.* §§ 72(t)(7)(A), 529(e)(3).
141. *Id.* § 72(t)(7)(A).
142. *Compare* I.R.C. § 4974(c), *with* I.R.C. §§ 7701(a)(37), 408(a), (b).
143. I.R.C. §§ 7701(a)(37), 408(a), (b).
144. *See Id.* § 72(t).
145. *See Id.* § 1.

a. Applying the Calculation to Pete's Unfortunate Circumstances

We know Pete made $75,000 from his job this year and that Pete files jointly with his wife. We also know that applying the standard deductions and exemptions, Pete's adjusted gross income is $56,300, and thus Pete falls within the 15% marginal tax bracket.[146] According to his plan, Pete can receive a hardship distribution of $155,000. Since a hardship withdrawal is considered income, this amount is added to his gross income.[147] Therefore, this year, for purposes of income taxes, once Pete takes the $155,000 hardship distribution, Pete's gross income will equal $211,300 ($56,300 + $155,000). Since Pete's income moves above $209,250 but not over $373,650, this forces Pete into the 33% marginal tax bracket.[148] Pete's marginal tax rate has gone up 18 percentage points. In addition, Pete will be assessed a 10% early distribution penalty on his entire hardship distribution.[149] The calculation of this 10% early distribution penalty is as follows: $155,000 (the entire amount of the hardship distribution) minus $59,375 (the amount of Pete's wife's medical bills excluded by the Exception 1),[150] equals $95,625. 10% of $95,625 is $9,562.50. Thus, the 10% early distribution penalty amounts to $9,562.50.

In order to truly understand what this all means, consider this: if Pete was taxed at his original marginal rate of 15%, his total income tax would equal $1,675 plus 15% of the excess over $16,750.[151] Pete's total income, including the $155,000 hardship distribution is $211,300 ($56,300 + $155,000). $211,300 minus $16,750 is $194,550. 15% of $194,550 is $29,182.50. $1,675 plus $29,182.50 equals $30,857.50. Thus, at a 15% marginal tax rate, Pete's total income tax would have been $30,857.50.[152] In addition, Pete would have to pay $9,562.50 based on the application of the 10% early distribution penalty.[153] Therefore, Pete's total tax burden at his original 15% marginal tax rate would have been $40,420 ($30,857.50 + $9,562.50).

146. *See supra* Part IV.A.
147. *Id.*
148. Rev. Proc. 2009-50, 2009-45 I.R.B. 8.
149. *See infra* Part IV.C.
150. *See infra* Part IV.C.
151. Rev. Proc. 2009-50, 2009-45 I.R.B. 7.
152. *See id.*
153. *See* previous paragraph.

However, since the hardship distribution forces Pete into the 33% marginal tax bracket, Pete's total income tax equals $46,833.50 plus 33% of the excess over $209,250.[154] $211,300 (Pete's adjusted gross income including the hardship distribution) minus $209,250 equals $2,050. 33% of $2,050 is $676.50. $46,833.50 plus $676.50 equals $47,510. Thus, at a 33% marginal tax rate, Pete owes $47,510 in income tax.[155] Additionally, Pete has to pay $9,562.50 based on the application of the 10% early distribution penalty. Therefore, at a 33% marginal tax rate, Pete's total tax burden is $57,072.50 ($47,510 + $9,562.50).

As a result, Pete's total tax burden has increased by $16,652.50 ($57,072.50 - $40,420), or approximately 41%. After payment of these taxes and penalties, Pete's $155,000 hardship distribution will not amount to much. The calculation is as follows: $211,300 (Pete's total adjusted gross income including the hardship distribution) minus $57,072.50 (Pete's total tax burden at a 33% marginal tax rate) minus $56,300 (Pete's adjusted gross income before the $155,000 hardship distribution) equals $97,927.50. Thus, assuming Pete lives in a state without state income tax, Pete's $155,000 hardship distribution is only worth $97,927.50.

In order to actually receive $155,000, the amount necessary to satisfy his "deemed" need under the rules,[156] Pete will have to take out a lot more. According to the rules, Pete is allowed to increase his hardship withdrawal to the extent necessary to cover taxes and penalties.[157] This additional money, however, is still regarded as income, and thus is subject to income tax.[158] To actually receive $155,000 in his pocket, Pete will have to take a hardship withdrawal of $240,183. Luckily, this option is available to Pete, because his elective contributions total $245,000. If this were not the case, this option might not be available at all.[159] Assuming Pete takes a $240,183 hardship withdrawal, his adjusted gross income will total $296,483 (Pete's original adjusted gross income + $240,183). At this amount, because Pete's income is over $209,250 but not over $373,650, Pete will remain within the 33% marginal tax

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154. Rev. Proc. 2009-50, 2009-45 I.R.B. 7.

155. *See id.*

156. *See supra* Part III.C.2.a.

157. Treas. Reg. § 1.401(k)-1(d)(3) (2009).

158. *See id.*

159. Hardship withdrawals are typically limited to the amount of the participant's elective contributions. *See* Treas. Reg. § 1.401(k)-1(d)(2)(ii); Treas. Reg. § 1.401(k)-1(d)(3)(ii).

bracket. Pete's income tax will therefore equal $46,833.50 plus 33% of the excess over $209,250.[160] Pete's adjusted gross income of $296,483 minus $209,250 equals $87,233. Thirty-three percent of $87,233 is $28,787. Pete's income tax of $46,833.50 plus $28,787 equals $75,620.50. Thus, Pete will owe $75,620.50 in income tax.

Moreover, Pete will owe $9,562.50 based on the application of the early withdrawal penalty. Therefore, Pete's total tax burden will be $85,184 ($75,620.50 + $9,562.50).[161] In the end, in order to actually get $155,000 in his pocket, Pete's total tax burden would have increased by $44,762.50 ($85,183.50 - Pete's total tax burden at a 15% marginal tax rate), or 111%. A total of $155,000 of Pete's own money will actually cost him $240,183. This leaves Pete with only $249,817 out of the $540,000 in his retirement account. The calculation is $540,000 (the amount in Pete's retirement account) minus $50,000 (Pete's plan loan) minus $240,183 (Pete's hardship distribution), and equals a balance in Pete's retirement account of $249,817. Furthermore, as if this is not bad enough, the IRS imposes yet another penalty.

C. Penalty Three: Six Month Suspension

If a plan adopts the "deemed" safe harbor rule for determining whether the distribution is necessary to satisfy the need, part three of that rule requires that the plan suspend the participant's contributions to the plan for at least six months.[162] This particular provision, however, not only suspends participant contributions for 6 months, but in effect, it precludes participants from receiving employer matching contributions.[163] Not surprisingly, this takes a significant toll on retirement savings.

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160. Rev. Proc. 2009-50, 2009-45 I.R.B. 7.
161. $296,483 (Pete's total income) - $85,183.50 (Pete's total tax burden) = $211,300. $211,300 - $56,300 (Pete's original adjusted gross income) = $155,000.
162. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E) (2009).
163. *See id.*

Figure 1

401(k) Account Balance at Age 65			
Age at which hardship withdrawal is taken	With no suspension	With 6-month suspension	Potential losses attributable to suspension of contributions
25	$540,023	$533,886	$6,137
35	$560,661	$552,574	$8,088
45	$570,933	$562,860	$8,073
55	$578,337	$572,064	$6,272

Illustration of the Effect of Suspending Participant Contributions Following a $5,000 Hardship Withdrawal on a Medium-Income Participant's Account Balance at Age 65[164]

As we know, Pete's plan has adopted this provision, and Pete's employer matches his contributions. Thus, for six months after Pete receives the hardship distribution, he will be prohibited from making contributions to his account. To make a bad situation even worse, Pete is also missing out on his employer matching contributions during this period. $155,000 has been taken out of his account, and for six months, even if Pete had money to contribute, he would not be able to put anything back in.

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164. GAO REPORT, *supra* note 31, at 34. GAO based its calculations upon the following facts:

> [A]n individual who is born at the beginning of 1970, begins participating in a 401(k) plan at age 21 in 1991, and retires at age 65 in 2035. We adopt the intermediate interest and rate-of-return assumptions as reported in past and projected in Social Security's most recent *2009 OASDI Trustees' Report*. Employee contributions are 6 percent and receive a 3 percent employer matching contribution. The $5,000 hardship withdrawals incur a 10 percent tax penalty for early withdrawal and are taken out at the beginning of the year that the individual reaches the age indicated. We contrast the age 65 401(k) account balance when participant contributions and employer matching contributions are suspended for a period of 6 months and when contributions continue without suspension. In this table, we calculated the forgone savings associated with the suspension of a 6 percent employee contribution and a 3 percent employer matching contribution for a period of 6 months. Totals do not add due to rounding.

Id at 34.

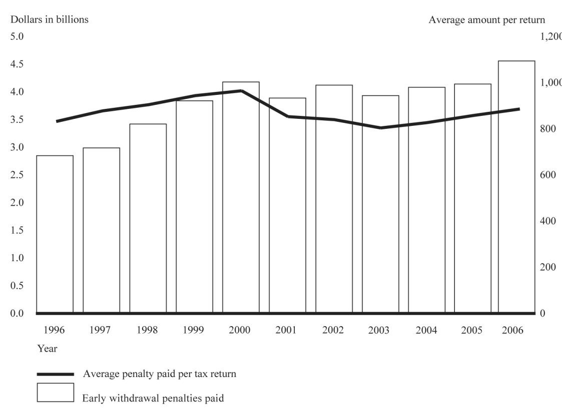
V. JUSTIFICATION OR PUNISHMENT?

A. PURPOSE OF THE 10% EARLY DISTRIBUTION PENALTY

Treasury officials have stated that the 10% early distribution penalty's purpose is twofold: 1) it is designed to deter participants from using their retirement savings when other sources are available; and 2) it enables the federal government to recover part of the subsidy provided so it can keep 401(k)/403(b) money tax deferred.[165] Its deterrent effect is questionable, however, as there is no question that the IRS is recovering part of the subsidy provided.[166] According to the IRS, participants in 401(k) plans and employees with IRAs paid $4.6 billion in penalties in 2006.[167]

Figure 2

Penalty Taxes Paid on Early Withdrawals from Qualified Retirement Plans and Average Penalty Paid, 1996 through 2006[168]



165. GAO REPORT, *supra* note 31, at 28–29.

166. *Id.* at 29.

167. *Id.*

168. *Id.* This chart includes 401(k) participants and participants in other qualified retirement plans, including IRAs. *Id.* Thus, this chart does not isolate the total amount of penalties paid specifically by 401(k) and 403(b) participants. *Id.* All dollar amounts reported are shown in constant 2008 dollars. GAO REPORT, *supra* note 31, at 29.

1. *Experts Say that the 10% Early Distribution Penalty is Working*

Experts say that the 10% early distribution penalty has likely reduced the amount and occurrence of leakage from retirement savings accounts.[169] Some experts, however, say that its function as a deterrent should be strengthened by increasing the penalty percentage.[170] For example, one expert stated that young workers may consider a distribution to be "free money" if they receive the distribution upon leaving their first job.[171] To these young workers, the 10% early distribution penalty merely affects what is already considered to them as "free money."[172] Another expert noted that for higher income participants, the 10% early distribution penalty "served more as a speed bump than a deterrent."[173]

Nevertheless, at least some experts agree that the 10% early distribution penalty serves as a deterrent regardless of amount because participants are generally reluctant to pay penalties.[174] Still, there thankfully remain some experts who realize that under certain circumstances, the 10% early distribution penalty does absolutely nothing to deter participants.[175] Participants truly faced with hardships will take withdrawals regardless of the amount of the penalty.[176]

B. Purpose of the Six Month Suspension

The concept of suspending a participant's contributions after a hardship withdrawal is not a recent development. In fact, a suspension period appeared in the very first final regulations issued in 1988.[177]

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169. *Id.* at 28.
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*
174. GAO Report, *supra* note 31, at 28.
175. *Id.*
176. *Id.*
177. Treas. Reg. § 1.401(k)-1(d)(2)(iii)(B)(*3*), enacted by T.D. 8217, 1988-2 C.B. 69. The regulations during that time period also required that:

> [t]he plan, and all other plans maintained by the employer, provide that the employee may not make elective contributions for the employee's taxable year immediately following the taxable year of the hardship distribution in excess of the applicable limit

From 1988 until 2002, this suspension period remained unchanged. Under this regulation, in order to comply with the "deemed" safe harbor rules, plans were required to suspend the participant's contributions for "at least 12 months."[178] Mercifully, in 2002, the Secretary of the Treasury was directed to reduce this 12 month suspension requirement to six months by the Economic Growth Tax Relief Reconciliation Act (EGTRRA).[179] In providing the reasons for this change, Congress stated that although they:

> [B]elieved that it is appropriate to restrict the circumstances in which [hardship distributions are] permitted and to encourage participants to take such distributions only when necessary to satisfy an immediate and heavy financial need, [that they were] concerned about the impact of a 12 month suspension of contributions on the retirement savings of a participant who experiences a hardship. Congress believed that the combination of a 6 month contribution suspension and the other elements of the regulatory safe harbor would provide an adequate incentive for a participant to seek sources of funds other than his or her 401(k) plan account balance in order to satisfy financial hardship.[180]

In 1981, the Federal Register published proposed amendments to the Treasury Regulations under sections 401(k) and 402(a)(8) of the IRC.[181] The amendments were proposed to conform the regulations to

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> under [I.R.C.] section 402(g) for such next taxable year less the amount of such employee's elective contributions for the taxable year of the hardship distribution.

Treas. Reg. § 1.401(k)-1(d)(2)(iii)(B)(*4*).

178. *Id.*

179. Economic Growth Tax Relief Reconciliation Act, Pub. L. No. 107-16, § 636 (a), 115 Stat. 38, 117 (2001). In addition, the EGTRRA eliminated the pre-2—2 requirement that a plan and all other plans maintained by an employer to limit a participant's elective contributions for the next tax year, the tax year immediately following the distribution, to the applicable limit under § 402 (g) for that year, minus the employee's elective contributions for the year of the hardship distribution. *Id.*; *see also* I.R.S. Notice 2002-4, 2002-1 C.B. 298. A plan is not required to eliminate an existing post hardship contribution limit unless the plan relies on the matching contribution safe harbor under I.R.C. § 401(k)(12) or I.R.C. § 401(m)(11).

180. STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS 122 (Comm. Print 2003), *available at* http://www.jct.gov/s-1-03.pdf.

181. Certain Cash or Deferred Arrangements Under Employee Plans, 46 Fed. Reg. 55544 (proposed Nov. 10, 1981) (to be codified at 26 C.F.R. pt. 1).

section 135 of the Revenue Act of 1978.[182] These amendments did not contain the "deemed" safe harbor rules.[183] The final regulations, published seven years later, however, did contain the "deemed" safe harbor rules.[184] Surprisingly, between 1981 and 1988, there is no commentary or reference within the Federal Register or Congressional Record relating to why this 12 month suspension was adopted.[185] Nevertheless, treasury officials have stated that the six month suspension serves as a test to ensure: 1) that the hardship is real; and 2) that the participant does not have any other assets available that would satisfy the need.[186]

1. Experts Say that the Six Month Suspension Does Not Serve Its Intended Purpose and Recommend that the Provision be Shortened or Eliminated

Several experts have stated that the suspension does "little to deter participants from making hardship withdrawals," and that it actually "may exacerbate the long-term effects of leakage" from retirement accounts.[187] One expert has said that while the suspension may serve as a deterrent in theory, that in reality, it only affects those participants who are already facing hardship.[188] Other experts have pointed out that the suspension provision "contradicts the goal of creating retirement income."[189] One expert has noted that the suspension provision also

182. Act of Nov. 6, 1978, PL 95–600, 92 Stat. 2763, 2785 (1978).

183. *See* 46 Fed. Reg. 55544.

184. Income Tax; Taxable Years Beginning After December 31, 1953 and OMB Control Numbers Under the Paperwork Reduction Act; Certain Cash or Deferred Arrangements Under Employee Plans, 53 Fed. Reg. 29658 (proposed Aug. 8, 1988) (to be codified at 26 C.F.R. pt. 1 & 602).

185. After performing a search on Westlaw using several databases, including Federal Taxation Combined Materials (FTX-ALL) and Legislative History - U.S. Code, 1948 to present (LH), with the search terms "12 months after receipt of hardship distribution" and several other similar search terms, no documents could be found between the years 1981 and 1988. A comparable search was also conducted on LexisNexis which yielded the same results. Moreover, we placed several calls to the IRS with no success. IRS Officials simply directed us to the same sources which we had already exhausted. Furthermore, the Tax Reform Act of 1984, Pub. L. 99-514, 110 Stat. 2085 (1986), makes no reference to a 12 month suspension.

186. GAO REPORT, *supra* note 31, at 33.

187. *Id.*

188. *Id.*

189. *Id.*

unnecessarily prevents participants who are able to make contributions from doing so.[190] For example, this could be the case when a participant takes a distribution for an isolated, one-time event, like the purchase of a principal residence.[191] Other experts have stated that the suspension period is excessive and "more of an inconvenience than an effective deterrent."[192] Another expert pointed out that participants who legitimately need money are left with 50% or less of the money they took out in hardship withdrawals after paying taxes and penalties.[193] Numerous experts have recommended that the suspension provision be shortened or eliminated entirely.[194] These same experts have stated that, if the suspension period is not repealed entirely, Congress should at least permit participants to "keep their employer match during the suspension period to begin making up lost ground."[195] The Government Accountability Office ("GAO") agrees with these experts. In a recent report, the GAO concluded that in order to help participants quickly recover after receiving a hardship distribution, Congress should change the 6 month requirement.[196]

VI. CONCLUSION

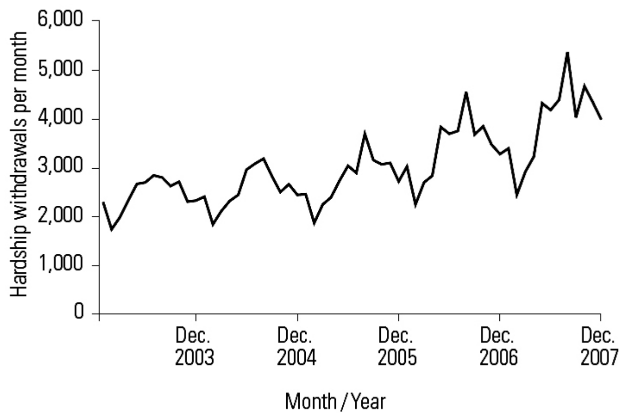
A. MORE EXCEPTIONS TO THE 10% EARLY DISTRIBUTION PENALTY SHOULD BE ADOPTED

Although it appears that the 10% early distribution penalty does its job by deterring participants from raiding their retirement accounts, its objective of deterrence is not achieved in the case of participants who are truly experiencing hardship. In reality, participants like Pete will take hardship withdrawals regardless of the penalty assessed. Therefore, in situations like his, deterrence becomes essentially irrelevant and the 10% early distribution penalty does nothing but make a bad situation even worse. Pete's taking is justified, and there is no reason that the IRS should profit from his hardship. In essence, the assessment of the 10% early distribution penalty is "irrational'' in the case of participants like

190. *Id*.
191. *Id*.
192. *Id*.
193. *Id*.
194. *Id*.
195. *Id*.
196. *Id*. at 35–36.

Pete. For thirty-three years Pete has been diligently saving his money to ensure his retirement; but today his retirement is anything but ensured. Although the IRS claims that the goal of the 10% early distribution penalty is to keep money in retirement accounts, its application does just the opposite. In fact, 4.6 billion dollars were paid in penalties in 2006.[197] With the economy in its current state, this number will only continue to rise.[198]

<u>*Figure 3*</u>
Number of Hardship Withdrawals Taken from Defined Contribution Plans[199]



197. *Id.* at 29.
198. "[H]ardship withdrawal information is one of the most sought after items on this website." *Hardship Withdrawals Give Access to Your 401k Savings, But at a Cost*, 401KHELPCENTER.COM, http://www.401khelpcenter.com/401k_education/hardship_withdrawal_article.html (last visited April 24, 2010).
199. William E. Nessmith & Stephen P. Utkus, *Research Note: Hardship Withdrawals and the Mortgage Crisis*, VANGUARD, Fig. 1 (Apr. 2008), https://institutional.vanguard.com/iip/pdf/CRRHP.pdf.

Figure 4
Dollar Amount of Hardship Withdrawals[200]

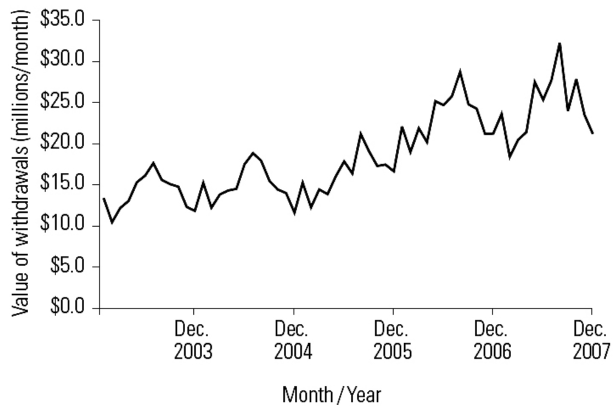
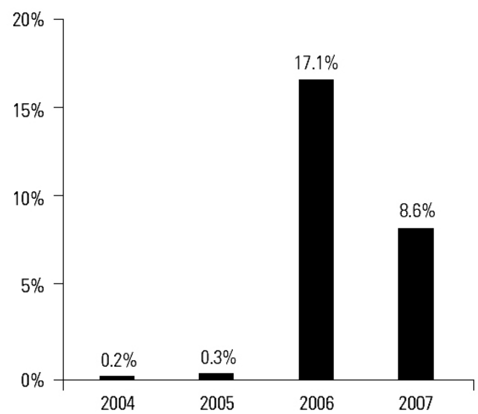


Figure 5
Percentage Increase in Hardship Withdrawals Over the Prior Year[201]



Not surprisingly, this 10% early distribution penalty has been found to have a regressive affect.[202] Lower income participants pay a larger percentage of their income than do higher income taxpayers.[203] This

200. *Id.*
201. *Id.* at 2. The dollar values reported are normalized for the growth in the plan as well as the participant base. *Id.*
202. Susan E. Anderson, *Is the Penalty Tax for Premature Individual Retirement Account Withdrawals Regressive?*, 95 TAX NOTES TODAY 147-81 (July 28, 1995).
203. *Id.*

proves that the 10% early distribution penalty does not serve any intended purpose. Although the penalty may deter some participants from taking money out of their retirement accounts, it is more likely to hurt those who are truly in need. Because lower income participants are less likely to have other sources available, they are more likely to take hardship withdrawals.

In order to solve this problem, more exceptions to the distribution penalty need to be adopted. Congress has moved in the right direction by providing numerous exceptions to the penalty,[204] but these exceptions are not enough. Participants who legitimately need money: 1) to repair their home; 2) to save their home from foreclosure; 3) to pay for their child's college tuition; or 4) to bury their parents, are still subject to the 10% early distribution penalty even though these expenses fall within the "deemed" safe harbor rule for determining the existence of an immediate and heavy financial need. There appears no reason why these three expenses should not be included in the exceptions. In fact, by including these expenses in its safe harbor rules, the IRS has already admitted that these expenses fall within their definition of hardship. If this is the case, why should participants be penalized for taking a hardship withdrawal when they truly need it?

Pete's unfortunate circumstances, although extraordinary, provide an excellent example of the unintended consequences that can flow from the 10% early distribution penalty. As mentioned earlier, Pete will be allowed to increase his hardship withdrawal amount to pay for reasonably anticipated taxes and penalties. However, in order to actually receive $155,000, the amount that he is "deemed" to need by the safe harbor rules, Pete will have to take out $240,183. $85,183 of Pete's hard earned money goes to the IRS. The IRS has told us that this occurs in order "to deter participants from taking hardship withdrawals when there are other sources available."[205] Yet, as we have explored, Pete has no other sources available and could prove this if required. Nonetheless, since there are no exceptions in place for: 1) expenses to repair one's home; 2) expenses needed to prevent foreclosure of one's principal residence; 3) expenses needed to pay for higher education; and 4) expenses needed to pay for funeral and burial expenses, Pete's retirement fund has unnecessarily been reduced by tens of thousands of dollars.

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204. *See* I.R.C. § 72(t) (2006).
205. GAO REPORT, *supra* note 31, at 28–29.

B. THE SIX MONTH SUSPENSION OF CONTRIBUTIONS SHOULD BE REPEALED

Like the 10% early distribution penalty, the six month suspension of contributions conflicts with the goal of creating and maintaining retirement savings. Not only are able participants prohibited from contributing to their accounts by suspending contributions, but employers are given a windfall. Employers are not required to continue to make contributions they otherwise would be required to make. The overall effect on retirement savings is hardly insignificant.[206] Like the IRS, there is no reason why employers should benefit from a participant's hardship.

Moreover, the month suspension, like the 10% early distribution penalty, does nothing to deter those participants who are legitimately facing a hardship, again undermining one of the IRS' stated reasons for its application. Furthermore, the IRS has said that the 6 month suspension serves as a test to make sure the hardship is real, but this test is not necessary where a participant is willing to show that they have no other sources "reasonably available" to them. Under the "facts and circumstances" test for determining the amount necessary to satisfy an immediate and heavy financial need, all the participant is required to do is swear that there are no other sources reasonably available to them. There is no requirement that they make an actual investigation into the participant's financials. The "deemed" safe harbor rules should offer a choice: 1) accept the six month suspension; or 2) provide documentation proving that there are no other sources reasonably available.

VII. PETE'S BITTER-SWEET ENDING

Today, although Pete realizes that he has no chance of retirement and that he will be working for the rest of his life, he can breathe a little easier. After taking a plan loan and hardship withdrawal, Pete was able to make his regrettable circumstances a little less unfortunate. Using the money from his hardship withdrawal, he was able to save his house, pay his wife's medical bills, keep his daughter in college, and give his mother the funeral she deserved. But because neither his best friend's surgery nor his brother's mortgage fell within the "deemed" safe harbor rules, he was forced to make a difficult decision. He had already taken

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206. *See supra* Part IV.B.

the maximum loan amount and the $50,000 plan loan could only pay for one or the other. His best friend's surgery was a long shot, but it could save his life. His brother's mortgage was a sure thing.

In the end, Pete decided to apply his loan money to his best friend's surgery. Miraculously, since then, his best friend has made a full recovery. Pete's brother's family has been living in his basement for the past 12 months. Thankfully, three weeks after they moved in, Pete's brother landed a promising job. They are planning on moving out next month.