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CORRESPONDENCE MEMORANDUM

DATE: October 11, 2012

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Deferred Compensation Director

SUBJECT: Financial Emergency Hardship Withdrawal Policy

The Board is asked to consider approving the attached policy relating to unforeseeable financial emergency hardship withdrawals for incorporation in the *Board Governance Manual*.

To further strengthen the Board's governance foundation, the Department of Employee Trust Funds submits for consideration the attached draft policy on financial emergency hardship withdrawals. The Wisconsin Deferred Compensation Program (WDC) is required to follow the Internal Revenue Code (IRC) and Wisconsin Administrative Code Chapter ETF 70.10 when granting a financial emergency hardship withdrawal (also sometimes called an unforeseeable emergency).

According to the Internal Revenue Service (IRS) and *Treasury Regulation 1.457-(c),* an unforeseeable emergency is a "**severe financial hardship** to the participant or beneficiary resulting from a sudden and unexpected illness or accident of the participant, or beneficiary, the spouse of the participant or beneficiary, or of a dependent of the participant or beneficiary; loss of a participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary and certain dependents."

Examples include:

- imminent foreclosure on or eviction from the participant's primary residence
- loss of regular income due to circumstances beyond the participant's control
- medical expenses, including nonrefundable deductibles and medications
- funeral expenses of a participant's spouse, beneficiary or dependent

Reviewed and approved by Matt Stohr, Administrator
Division of Retirement Services

Matt Stohr 10/11/12
Signature Date

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The unforeseeable emergency must be based on a financial hardship actually *experienced*, not one that is *expected to* or *may* happen. A participant must prove they are experiencing a severe financial emergency and provide evidence they have exhausted all other sources of income. Other sources may include:

- reimbursement or compensation from insurance
- liquidation of assets to the extent that this would not cause a severe hardship
- cessation of deferrals

Under IRS regulations, the following are not typically considered financial emergencies:

- the purchase of a house or other real estate
- school tuition or other educational expenses
- normal, ordinary living expenses such as: mortgage, auto payments or repair costs, home remodeling, utility bills, loans, delinquent taxes, overdue credit card bills, the purchase of major appliances, losses or cash flow problems on properties held for investment, and marital separation or divorce.

To date, there has been very limited additional federal guidance regarding what constitutes an unforeseen financial emergency. Revenue Ruling 2010-27 from the IRS lists just three examples of participant requests for unforeseen financial emergency distributions and the IRS' decision on each:

1. **"[To] repair significant water damage to the participant's principal residence not covered by insurance** - the distribution is allowable because the damage to the participant's primary residence is an extraordinary and unforeseeable circumstance and is substantially similar to the need to pay for damage to a home from a natural disaster.
2. **[To] pay funeral expenses of the participant's non-dependent adult son** - the distribution is allowable because it is for an extraordinary and unforeseeable circumstance and is substantially similar to the need to pay for funeral expenses of a dependent.
3. **[To] pay credit card debt** - the distribution is **not allowable** because it is not due to an extraordinary and unforeseeable circumstance or the result of events beyond the participant's control."[1]

The Board has reviewed WDC financial emergency hardship withdrawal regulations, trends and potential participant scenarios previously, most recently at the May 2012 Board meeting. At this meeting, the Board asked staff to evaluate whether to impose a twelve-month look back time limit and include criteria based on a participant's earnings, when evaluating hardship withdrawal recommendations. Staff concur that a twelve-month look back is appropriate and this is included in the attached policy.

However, staff does not recommend attempting to implement criteria based on a participant's earnings at this time. To do so would add another measurement to the administrative review process and further delay the process. ~~.~~ For example, participants would have to submit additional documentation and policy decisions must be made regarding at what level or levels

[1] http://www.irs.gov/retirement/article/0,,id=232436,00.html last accessed on March 3, 2012

of earnings a release would be appropriate, what might trigger the need to adjust the levels (e.g., a change in the federal poverty threshold) and when to make any adjustments. We queried twenty s. 457 peer respondents regarding this issue, and none reported that they use income thresholds when evaluating hardship applications. Further, staff does not believe including an earnings threshold would be consistent with the intent of the IRS guidelines.

Department staff will attend the November 6, 2012 meeting to answer any questions. If the Board is supportive of this policy as written or with amendments, it can be formally adopted and included within the *Board Governance Manual.*

Attachment: Financial Emergency Hardship Withdrawal Policy

Unforeseeable Financial Emergency Hardship Withdrawal Policy

Adopted: (draft for Board meeting November 2012)
Last Revised: (draft for Board meeting November 2012)

The Deferred Compensation Board's Unforeseen Financial Emergency Hardship Withdrawal Policy recognizes that each Wisconsin Deferred Compensation Program (WDC) participant's unforeseeable financial emergency hardship withdrawal reflects a participant's unique situation and must be evaluated accordingly. However, the decision to either allow or deny an unforeseeable financial emergency hardship withdrawal application is subject to each Section 457 plan provider's interpretations of the rules and how they apply to individual situations. Each participant's financial emergency hardship withdrawal application must be carefully evaluated, based on the unique facts and circumstances of that participant's particular situation. The key to administering financial emergency hardships is to apply the rules and procedures for these distributions to all participants consistently.

Background: The Wisconsin Deferred Compensation Program (WDC) is required to follow the Internal Revenue Code (IRC) and Wisconsin Administrative Code Chapter ETF 70.10 (attached) when granting a financial emergency hardship withdrawal (also called an unforeseeable emergency). Regulations under Section 457(b) of the IRC define an unforeseeable emergency as follows:

> **IRC Section 1.457-6 (c)**
> (2) Requirements – (i) Unforeseeable emergency defined. An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in Section 152(a)); loss of the participant's or beneficiary's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, e.g., as a result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse or dependent (as defined in Section 152(a)) may also constitute an unforeseeable emergency. Except as otherwise specifically provided in this paragraph (c)(2)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2)(i).
>
> (ii) Unforeseeable emergency distribution standard. Whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under this paragraph (c) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the participant's assets, to the extent the liquidation of such assets would not by itself cause severe financial hardship, or by cessation of deferrals under the plan.

(iii) Distribution necessary to satisfy emergency need. Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state or local income taxes or penalties reasonably anticipated to result from the distribution).

To date, there has been very limited additional federal guidance regarding what constitutes an unforeseen financial emergency. In particular, no substantial guidance exists to define what is meant by the terms "severe" or "unforeseeable". Revenue Ruling 2010-27 from the Internal Revenue Service (IRS) lists just three examples of participant requests for unforeseen financial emergency distributions and the IRS' decision on each:

1. **"[To] repair significant water damage to the participant's principal residence not covered by insurance** - the distribution is allowable because the damage to the participant's primary residence is an extraordinary and unforeseeable circumstance and is substantially similar to the need to pay for damage to a home from a natural disaster.
2. **[To] pay funeral expenses of the participant's non-dependent adult son** - the distribution is allowable because it is for an extraordinary and unforeseeable circumstance and is substantially similar to the need to pay for funeral expenses of a dependent.
3. **[To] pay credit card debt** - the distribution is **not allowable** because it is not due to an extraordinary and unforeseeable circumstance or the result of events beyond the participant's control."[1]

As noted in by the National Association of Government Defined Contribution Administrators (NAGDCA) documents on financial emergency hardship distribution requests, because there is no definitive list, plan administrators "have been left with what amounts to a subjective facts and circumstances test for adjudicating unforeseeable emergency withdrawal requests".

The following list of hardship situations is not meant to be all inclusive; rather, it is a sampling of situations that have been presented as financial emergencies in the past.

Selected WDC Financial Emergency Hardship Situations

Situation	**Appropriate for a Hardship Withdrawal?**	**Decision Notes**
Furloughs	Yes	Distributions may be allowed for furloughs experienced within the last twelve months, depending on each individual's circumstances.
Partner/spouse loss of income due to involuntary termination	Yes	A distribution may be allowed if the participant can document that the job loss was the result of an involuntary termination (layoff, etc.) and it was within the last twelve months.
Loss of income due to	Yes	A distribution may be allowed if a participant

[1] http://www.irs.gov/retirement/article/0,,id=232436,00.html last accessed on March 3, 2012

Selected WDC Financial Emergency Hardship Situations		
Situation	**Appropriate for a Hardship Withdrawal?**	**Decision Notes**
spousal/partner abandonment		can document the loss of income from the abandonment within the last twelve months via a copy of an income tax form or paycheck stub.
Loss of income due to increase in employee-paid share of Wisconsin Retirement System (WRS) pension contributions	No	A distribution is not allowable because WRS pension contributions are not truly "lost" income; the income is invested for the participant's future retirement via the WRS.
Loss of income due to increase in employee-paid share of group health insurance premiums	No	A distribution is not allowable because insurance premium increases are not due to extraordinary and unforeseeable circumstances.
Loss of income due to a divorce	No	A distribution is not allowable; divorce is neither extraordinary nor unforeseeable.
Loss of business income due to economic changes	No	A distribution is not allowable because typically this is not the participant's primary source of income, and business income losses may be relieved through other means (e.g. commercial sources).

Attachments
1. Ch. ETF 70.10: http://legis.wisconsin.gov/rsb/code/etf/etf070.pdf
2. National Association of Government Defined Contribution Administrators (NAGDCA):
    a. http://www.nagdca.org/content.cfm/id/nagdcanote20091118 (2009)
    b. http://www.nagdca.org/content.cfm/id/content.cfm/id/hardship_distributions (2008)
    c. http://www.nagdca.org/content.cfm/id/unforeseeable_emergency_withdrawals (2007)