

# Unforeseeable emergency and IRC Section 409A

Distributions from nonqualified deferred compensation plans may occur upon six permissible distribution events.<sup>1</sup> One of these permissible distribution events is upon an unforeseeable emergency. If a plan design allows, a participant may petition their employer to stop deferrals,<sup>2</sup> or stop deferrals and make a distribution from the plan upon the occurrence of an unforeseeable emergency.<sup>3</sup>

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from an illness or accident of the participant, their spouse, beneficiary or dependent,<sup>4</sup> the loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising because of events beyond the participant's control.<sup>5</sup>

The Treasury Regulations cite three examples of events that may constitute an unforeseeable emergency:

- Imminent foreclosure of the participant's primary residence
- The need to pay for medical expenses, including prescription drugs
- Funeral expenses of a spouse, beneficiary or dependent

Two examples of events that will not constitute an unforeseeable emergency:

- A purchase of a new home
- Payment of college tuition

The Treasury Regulations also state that a distribution cannot occur to the extent that the unforeseeable emergency can be relieved through insurance, or liquidation of assets that would not cause a severe financial hardship, or cessation of deferrals under the plan.<sup>5</sup> The distribution must be limited to the amount necessary to satisfy the emergency need, and taxes reasonably anticipated to result from the distribution.<sup>6</sup>

Additional IRS guidance provides examples of three situations that may or may not qualify as an unforeseeable emergency:<sup>7</sup>

- **Repair of 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 extraordinary and unforeseeable.
- **Pay funeral expenses of the participant's non-dependent adult son** - The distribution is allowable because it's for an extraordinary and unforeseeable circumstance that is substantially similar to the need to pay for funeral expenses of a dependent.
- **Pay credit card debt** - The distribution is not allowable because it's not due to an extraordinary or unforeseeable circumstance or the result of events beyond the participant's control.

Unforeseeable emergencies in deferred comp plans are rare due to their extreme nature and the requirement that insurance or other means be utilized prior to a distribution from the plan.

### **Participant requests a distribution due to unforeseeable emergency**

Plan sponsors should establish consistent procedures for closely reviewing a participant's request for a distribution due to an unforeseeable emergency. It's also recommended that plan sponsors follow the guidelines outlined above, as well as related code and regulatory guidance when making a determination whether to approve an unforeseeable emergency distribution request.

While the participant seeking the distribution must demonstrate that emergency expenses are not covered by insurance, and cannot be satisfied by liquidation of other assets or cessation of deferrals under the plan, the responsibility for determining whether the request meets the IRS definition of unforeseeable emergency lies with the plan sponsor.

Many plan sponsors ask the following questions as they determine whether the request meets the definition:

- Was this unforeseen?
- Does it constitute an emergency?
- Is this consistent or inconsistent with past determinations?
- Does sufficient documentation exist to show the circumstances?
- Is the emergency related to an eligible person?

In addition, plan sponsors may provide participants with a list of documentation they may require to help the sponsor determine if the request meets the definition. A sample of that documentation includes:

- Foreclosure or eviction notice
- Medical bills with proof insurance will not cover the expense
- Funeral bill for a covered dependent
- Repair bills due to loss of property
- Proof of dependency

As with any distribution from a nonqualified plan, a distribution due to an unforeseeable emergency is taxed to the participant.

### **Impact of a 401(k) hardship on deferred comp plan deferrals**

Participants in a 401(k) plan can be offered the availability of "hardship distributions."<sup>8</sup> A hardship has a different definition under Section 401(k) than an unforeseeable emergency has under Section 409A.<sup>9</sup> Some nonqualified deferred compensation plans may require deferrals to stop under the nonqualified plan if the plan document requires deferrals to be cancelled upon a 401(k) hardship.

<sup>1</sup> IRC Section 409A(a)(2)(A); Treas. Regs. Section 1.409A-3(a)

<sup>2</sup> Treas. Regs. Section 1.409A-3(j)(4)(viii)

<sup>3</sup> Treas. Regs. Sections 1.409A-3(a)(6), 1.409A-3(i)(3)

<sup>4</sup> As a dependent is defined in IRC Section 152

<sup>5</sup> Treas. Regs. Section 1.409A-3(i)(3)(i)

<sup>6</sup> Treas. Regs. Section 1.409A-3(i)(3)(ii)

<sup>7</sup> Revenue Ruling 2010-27, 2010-45 IRB 620

<sup>8</sup> See IRC Sec. 401(k)(2)(B)(i)(IV)

<sup>9</sup> See Treas. Reg. Section 1.401(k)-1(d)(3)(i). Please contact your qualified plan provider for information regarding qualified plan Hardships



[principal.com](http://principal.com)

Insurance products issued by Principal National Life Insurance Co (except in NY) and Principal Life Insurance Co. Plan administrative services offered by Principal Life. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., 800-247-1737, Member SIPC and/or independent broker/dealers. Principal National, Principal Life, Principal Funds Distributor, Inc. and Principal Securities are members of the Principal Financial Group®, Des Moines, IA 50392.

The subject matter in this communication is provided with the understanding that Principal® is not rendering legal, accounting, or tax advice. You should consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.

No part of this presentation may be reproduced or used in any form or by any means, electronic or mechanical, including photocopying or recording, or by any information storage and retrieval system, without prior written permission from the Principal Financial Group®.

Principal, Principal and symbol design and Principal Financial Group are trademarks and service marks of Principal Financial Services, Inc., a member of the Principal Financial Group.

BB12220-01 | 03/2020 | 1132178-032020 | ©2018-2020 Principal Financial Services, Inc.