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IRS Makes it Easier to Make Hardship Withdrawals and Plan Loans to Persons Affected by Hurricane Sandy

IRS Announcement 2012-44 (Nov. 16, 2012) provides liberal rules for loans and hardship distributions from tax-favored employer plans to taxpayers affected by Hurricane Sandy. This guidance generally mirrors helpful guidance issued by the IRS in 2005 after Hurricane Katrina. We summarize the new guidance and related issues below.

In addition to the retirement plan relief described below, the IRS has issued news releases which extend the deadlines for filing tax returns and submitting tax payments that would otherwise be required on or after October 26, 2012 for taxpayers located in the areas struck by Hurricane Sandy (see IRS News Release 2012-82 (10/31/12) and IRS News Release 2012-83 (11/2/12)). Of particular importance, the latter release extends certain tax filing deadlines until February 1, 2013, including individual income tax, excise and employment tax returns, and filing of the Form 990 for tax-exempt organizations. Moreover, the effect of News Release 2012-83 is to extend a host of other benefits-related deadlines, listed in Section 8 of Rev. Proc. 2007-56, including the deadline for filing Form 5500, until February 1, 2013.

Scope of Relief and Eligible Plans –Announcement 2012-44 permits certain hardship or emergency withdrawals and loans from tax-favored retirement plans to employees or former employees whose principal residence or place of employment on October 26, 2012 was located in one of the counties or Tribal Nations in Connecticut, New Jersey, New York, and Rhode Island that have been or are later designated as federal disaster areas by the President. (See below for the current list of counties and Tribal Nations to receive such designation.)

A loan or hardship distribution made in accordance with this guidance will only qualify for relief if it is made on or after October 26, 2012, and no later than February 1, 2013. Further, any distributions paid under this relief are limited to amounts that could otherwise be distributed as a loan or hardship (or emergency) distribution under the Code and regulations. This guidance covers Internal Revenue Code ("Code") section 401(k) and 403(b) plans as well as governmental eligible deferred compensation plans described in Code section 457(b). Defined benefit and money purchase plans may only permit such in-service hardship distributions if the amounts are withdrawn from a separate account in the plan, if any, containing employee contributions or from rollover contributions that are separately accounted for under Rev. Rul. 2004-12.

It is important to note that, in addition to hardship distributions and loans to affected participants, the Announcement provides potential relief for Sandy-related hardships of lineal ascendants or descendants of plan participants as well as spouses and dependents. In other words, if the plan allows it, a plan participant who lives in another part of the country can assist a son, daughter, parent, grandparent or other dependent who lived or worked in the affected areas by taking out a plan loan or hardship withdrawal under the guidance.

Plan Amendment Rules Relaxed – Plans are not required to take advantage of this guidance and may adopt some of the liberalizations, and not others. Under the Announcement, plans may make loans to affected employees or former employees whether or not the plan documents currently allow for such loans to be made, so long as the requirements of Code section 72(p) are met. Similarly, the plan does not currently need to provide for hardship distributions for affected employees or former employees to receive a hardship distribution. However, if participants are permitted to take loans or hardship distributions in accordance with this guidance, plans that do not currently provide for loans or hardship distributions must be amended to do so by the end of the 2013 plan year.

Flexible Administrative Guidelines – To ease administrative burdens, the Announcement allows plan administrators to rely on representations from affected employees or former employees as to the need for and amount of a hardship distribution, unless the plan administrator has actual knowledge to the contrary. Although plan administrators may suspend their normal procedural requirements (e.g., supporting documentation) during this relief period, they must make a good faith effort to comply with those requirements. Further, if required documentation is not obtained at the time of the distribution, the plan administrator must make a reasonable attempt to obtain such documentation as soon as practicable thereafter. The Announcement provides the following example –

If spousal consent is required for a plan loan or distribution and the plan terms require production of a death certificate if the employee claims his or her spouse is deceased, the plan will not be disqualified for failure to operate in accordance with its terms if it makes a loan or distribution to [an eligible recipient] in the absence of a death certificate if it is reasonable to believe, under the circumstances, that the spouse is deceased, the loan or distribution is made no later than February 1, 2013, and the plan administrator makes reasonable efforts to obtain the death certificate as soon as practicable.

The Announcement states that plans are not required to suspend contributions for up to 6 months for participants receiving a hardship distribution. However, it is unclear whether a plan sponsor or plan administrator must consider whether a participant can take a plan loan before a hardship distribution can be made (consideration of whether a loan can be taken is another “safe harbor” condition under the 401(k) regulations). Prior informal discussions with Treasury officials regarding the 2005 Hurricane Katrina guidance indicated that if a plan allows loans to participants, the plan administrator must make the participant take a loan before a hardship distribution can be made. If the plan does not allow loans, however, the plan administrator does not appear to be required to determine whether other sources may satisfy the need, and the plan administrator may make a hardship distribution pursuant to the good-faith relief under the Announcement. Later guidance has not clarified this issue.

Geographic Areas Affected – The President has declared federal disaster areas in Connecticut, New Jersey, New York and Rhode Island. The following counties and Tribal Nations have received such designation:

- Connecticut: Fairfield, Middlesex, New Haven and New London counties and the Mashantucket Pequot Tribal Nation and Mohegan Tribal Nation located within New London County.
- New Jersey: Atlantic, Bergen, Burlington, Camden, Cape May, Cumberland, Essex, Gloucester, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Ocean, Passaic, Salem, Somerset, Sussex, Union and Warren counties.
- New York: Bronx, Kings, Nassau, New York, Orange, Putnam, Queens, Richmond, Rockland, Sullivan, Suffolk, Ulster and Westchester counties.

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- Rhode Island: Newport and Washington counties.

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We would not be surprised to see Congressional legislation in the "lame duck" session liberalizing the statutory rules for pension distributions and/or plan loans, such as that enacted after Katrina in 2005. For example, the Katrina legislation doubled the loan limits, waived penalty taxes for plan and IRA distributions, and relaxed tax withholding requirements. Whether Congress can squeeze this in while it struggles to avoid the "fiscal cliff" – and agree on a compromise on the Bush-era tax cuts – remains to be seen.

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