

Section 409A.—Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans

26 CFR 1.409A-3: Permissible payments.

The revenue ruling provides guidance, in the form of examples, on what constitutes an unforeseeable emergency distribution under section 457(b) of the Code and section 1.457-6(c) of the regulations. The revenue ruling also applies the same standards to distributions from a nonqualified deferred compensation plan subject to section 409A. See Rev. Rul. 2010-27, page 620.

Section 457.—Deferred Compensation Plans of State and Local Governments and Tax-Exempt Organizations (Also Section 409A.—Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans)

26 CFR 1.457-6(c): Timing of distributions under eligible plans.
(Also 26 CFR 1.409A-3: Permissible payments).

This ruling provides guidance, in the form of examples, on what constitutes an unforeseeable emergency distribution under section 457(b) of the Code and regulations section 1.457-6(c). The ruling also applies the same standards to distributions from a nonqualified deferred compensation plan subject to section 409A.

Rev. Rul. 2010-27

ISSUE

Whether a plan is permitted to make an unforeseeable emergency distribution to a participant under § 457(d)(1)(A)(iii) of the Internal Revenue Code in the following factual situations?

FACTS

State X maintains Plan Y, an eligible deferred compensation plan under § 457(b) and § 1.457-2(f) of the Income Tax Regulations. Under the terms of Plan Y, a participant who has an unforeseeable emergency

before retirement or other severance from employment may request an unforeseeable emergency distribution.

The provisions of Plan Y governing unforeseeable emergency distributions are substantially similar to Section 5.10 of the Model Amendment contained in the Appendix to Rev. Proc. 2004-56, 2004-2 C.B. 376. Specifically, an unforeseeable emergency is defined in Plan Y as a severe financial hardship of the participant resulting from any of the following: an illness or accident of the participant, the participant's spouse, or the participant's dependent (as defined in § 152(a)); loss of the participant'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); the need to pay for the funeral expenses of the participant's spouse or dependent (as defined in § 152(a)); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The plan document provides various examples of an unforeseeable emergency, including the imminent foreclosure of, or eviction from, the participant's primary residence. The plan document states that, except as otherwise specifically provided, neither the purchase of a home nor the payment of college tuition is an unforeseeable emergency.

The plan document limits the amount of a distribution on account of an unforeseeable emergency to the extent that such emergency is or may be relieved either:

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 itself cause severe financial hardship; or by cessation of deferrals under Plan Y. While distributions because of an unforeseeable emergency may not exceed the amount reasonably necessary to satisfy the emergency need, Plan Y allows any distribution to include the amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

In each of the situations below, the plan participant requests a distribution to pay certain expenses, as well as an additional amount to pay federal, state, or local income taxes that will result from the distribution, and the participant provides adequate documentation under the facts and circumstances regarding the claimed expense, including the amount (if any) of insurance that will cover the expense and that the participant has no other source of funds to pay the expense.

Situation 1. Participant A requests an unforeseeable emergency distribution from Plan Y to pay for the cost of having A's principal residence repaired after significant water damage from a water leak, that was discovered in the basement. Participant A provides written estimates of the repair cost.

Situation 2. Participant B requests an unforeseeable emergency distribution from Plan Y to pay for funeral expenses for B's adult son, who is not a dependent (as defined in § 152(a)) of B. B provides a bill from the funeral home that itemizes the cost of the funeral expenses.

Situation 3. Participant C requests an unforeseeable emergency distribution from Plan Y to pay accumulated credit card debt, which is not due to any events that are extraordinary and unforeseeable circumstances arising as a result of events beyond the control of C.

LAW AND ANALYSIS

In order to be an eligible deferred compensation plan under § 457(b), a plan must satisfy the distribution requirements of § 457(d). Section 457(d)(1)(A) allows distributions to be made available only in certain events, which include when the

participant is faced with an unforeseeable emergency.

An unforeseeable emergency is defined in § 1.457-6(c)(2)(i) 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 § 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 the 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 a dependent (as defined in § 152(a)) may also constitute an unforeseeable emergency. However, the purchase of a home and the payment of college tuition are not considered unforeseeable emergencies.

Under § 1.457-6(c)(2)(ii), whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under § 457(d)(1)(A) is determined based on the relevant facts and circumstances of each case. In any case, however, a distribution on account of an 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 itself cause severe financial hardship, or by cessation of deferrals under the plan.

Under § 1.457-6(c)(2)(iii), a distribution due to an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need. However, the distribution may include any amount necessary to pay any federal, state, or local income taxes or penalties reason-

ably anticipated to result from the distribution.

A plan is not required to provide for distributions in all of the events permitted under § 457(d)(1)(A) in order to constitute an eligible deferred compensation plan under § 457(b). Further, if a plan provides for distributions due to an unforeseeable emergency under § 457(d)(1)(A)(iii), it is not required to include all of the events for which distributions are permitted under § 457(d)(1)(A)(iii) and § 1.457-6(c)(2)(i).

Section 5.10 of the Model Amendment published in the Appendix to Rev. Proc. 2004-56 provides for distributions under all of the conditions for which unforeseeable emergency distributions are permitted under the regulations, including not only a number of specific examples but also any other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. The terms of Plan Y are substantially the same as those in Section 5.10 of the Model Amendment.

The facts in *Situation 1* do not fit within any of the specific examples that are listed in § 1.457-6(c)(2)(i) or Plan Y as constituting an unforeseeable emergency. Nevertheless, § 1.457-6(c)(2)(i) and Plan Y also authorize distribution in other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The need to repair the principal residence because of significant water damage, that is not covered by insurance is an extraordinary and unforeseeable circumstance that arises as a result of events beyond the control of the participant and is substantially similar to the need to pay for damage to a home as a result of a natural disaster.

The facts in *Situation 2* also do not fit within any of the specific examples that are listed in § 1.457-6(c)(2)(i) or Plan Y as constituting an unforeseeable emergency. The need to pay for funeral expenses of a spouse or dependent is one of the examples that is listed in the regulation and the plan document as constituting an unforeseeable emergency, but the facts in *Situation 2* involve the death of an adult son who is not a dependent (as defined in § 152(a)) of the participant. Nevertheless, § 1.457-6(c)(2)(i) and Plan Y also authorize payment in other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the

control of the participant. The need to pay for the funeral expenses of a non-dependent adult son is an extraordinary and unforeseeable circumstance that arises as a result of events beyond the control of the participant and that is substantially similar to the need to pay for the funeral expenses of a dependent.

The facts in *Situation 3* do not fit within any of the specific examples set forth in § 1.457-6(c)(2)(i) or Plan Y as constituting an unforeseeable emergency, nor do they present facts indicating that an unforeseeable emergency circumstance has arisen as a result of events beyond the control of the participant.

HOLDINGS

In *Situation 1* and *Situation 2*, Plan Y is permitted to provide unforeseeable emergency distributions to Participant A and Participant B under § 457(d)(1)(A)(iii).

In *Situation 3*, Plan Y is not permitted to provide an unforeseeable emergency distribution to Participant C under § 457(d)(1)(A)(iii).

APPLICATION OF ANALYSIS TO PLANS SUBJECT TO § 409A

Section 409A(a) applies to amounts deferred under a nonqualified deferred compensation plan. If such a plan fails to meet the requirements of § 409A(a), all amounts deferred under the plan for that taxable year and all previous taxable years are includible in income and subject to additional taxes. As provided in § 409A(a)(2)(A), one of the requirements of § 409A(a) is that the nonqualified deferred compensation plan provide that amounts deferred under the plan are payable only upon one or more of the specified events listed in the statute, which include the occurrence of an unforeseeable emergency. Although a plan described in § 457(b) is not subject to § 409A, the definition of “unforeseeable emergency” under § 1.409A-3(i)(3) is substantially similar to the definition of “unforeseeable emergency” under § 1.457-6(c)(2)(i). Accordingly, the principles and rulings set forth in this revenue ruling apply to an amount deferred under a nonqualified deferred compensation plan subject to § 409A(a) that may be paid under the terms of the plan upon the occurrence of an event constituting an unforeseeable

emergency that complies with § 409A(a) and § 1.409A-3(i)(3).

DRAFTING INFORMATION

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