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401(k) Plan Hardship Withdrawals for Casualty Losses

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Consider two fact situations. In one, relatively modest damage occurs to a 401(k) plan participant's principal residence attributable to a hurricane in a federally declared disaster area. In the other situation, lightning strikes a 401(k) plan participant's principal residence and the home, which is outside of a federally declared disaster area, is completely destroyed. Which of these situations might result in a hardship withdrawal from a 401(k) account?

In-service withdrawals from 401(k) plan accounts are restricted by statute, regulations and plan design. Treasury regulations allow in-service hardship withdrawals from 401(k) accounts for certain types of immediate and heavy financial needs, including "Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income)." The plan document would also have to provide for a withdrawal on this basis before it would be permitted.

Generally, prior to 2018 to be deductible under Section 165 of the Internal Revenue Code a casualty loss must have been the result of a sudden, unexpected or unusual event, such as a fire, flood, hurricane, etc., and the loss must not have been covered by insurance or some other source. Thus, even a small, uninsured casualty loss could be the basis for a 401(k) account withdrawal, provided that the other requirements were satisfied (e.g., no other reasonably available resources to satisfy the need).

Effective in 2018, the Tax Cuts and Jobs Act amended the casualty loss provisions of Code Section 165 to provide that a personal casualty loss is not deductible for federal income tax purposes unless the loss occurs in an area declared to be a federal disaster area. In addition, the loss must be attributable to the events giving rise to declaration of disaster area status.

401(k) plans are typically written to limit hardship withdrawals to the "safe harbor" reasons stated in the Treasury regulations, such as that stated above for casualty losses of a deductible type. A 401(k) plan is required by federal law to be administered in accordance with its terms. Thus, as the law now exists, and under the terms of nearly all 401(k) plans, a hardship withdrawal will not be permitted unless the hardship is of a casualty type which previously qualified as deductible, and it occurs in an area declared as a federal disaster area, and the loss is "attributable to" the reason for the declaration of disaster area status. Under current law, of the two situations described above the minor hurricane-related damage which occurred in a declared disaster area might satisfy the regulation, but the complete destruction of a house outside of a federal disaster area would not. Note that major damage from the same hurricane as that in the first situation would not qualify if it occurred in an adjoining county which was not within the declared disaster area. There may also be situations where it isn't clear whether, or how much of, a loss is attributable to the reason for the declaration of disaster area status.

This change in hardship withdrawal availability is likely not an intended result of the change in deductibility of personal casualty losses under the Act. In fact, it would have the opposite effect. The change was intended to increase current tax revenues to the federal government. Denying access to a hardship withdrawal for casualty losses outside of a federal disaster area would actually decrease current tax revenues, because, if allowed, the

withdrawn amount would have been currently taxable. As a result, it seems very possible that the Treasury regulations regarding hardship withdrawals may be revised or other guidance may be issued to allow hardship withdrawals for otherwise qualified casualty losses, even if they do not occur in a federally declared disaster area.

However, a 401(k) plan must still be administered in accordance with its terms, so even if the Treasury regulations are amended, or other reliable Treasury guidance is issued, a plan amendment would likely be required if the plan is going to allow casualty-related withdrawals which occur outside of a disaster area. Absent a regulation change or other regulatory relief, if an amendment is adopted to permit hardship withdrawals for a casualty loss which occurs outside of a federally declared disaster area the plan risks a loss of its pre-approved or favorable determination letter status, though either such result seems unlikely. On the other hand, if such withdrawals are allowed without a plan amendment, the tax qualification of the plan could be challenged by the IRS, though an inadvertent operational error might well be viewed as "insignificant" on IRS audit, in which case correction without adverse effect might be possible. The bottom line here is that the documents and circumstances surrounding a casualty loss hardship withdrawal request should be considered carefully.

There are, of course, requirements for a hardship withdrawal other than the type of need – in this case an uncovered casualty loss which occurs in a federally declared disaster area. Those other requirements must also be taken into account.

If you have any questions regarding the content of this alert, please contact [Bill Robinson](#) or any member of the Firm's [Tax Group](#).