

# Employee Benefit Plan Review

## Ask the Experts

BY MARJORIE M. GLOVER, DAVID GALLAI, AND RACHEL M. KURTH

### 401(K) PLAN HARDSHIP WITHDRAWALS FOR PRINCIPAL RESIDENCE REPAIRS

**Q** My company's 401(k) plan permits hardship withdrawals and uses the Internal Revenue Code's "safe harbor" definition. One of our participants has requested a hardship withdrawal to finance repairs to his principal residence resulting from a hot water heater leak that caused water damage and mold on his wood floors. We would like to permit this hardship withdrawal, but are concerned that we will not be able to do so, because the damage was not due to a federally declared natural disaster. Are we permitted to allow the participant to make the hardship withdrawal?

**A** Possibly. In November 2018, the Internal Revenue Service (IRS) issued proposed regulations on hardship withdrawals. Taxpayers may rely on the proposed hardship withdrawal regulations until the date that final regulations are published. If your plan document permits you to do so, you could rely on those proposed regulations, which may enable your company to permit the hardship withdrawal (assuming the other requirements for a hardship withdrawal are satisfied and the hardship request is substantiated).

Before 2018, as long as the participant met the other requirements for a hardship withdrawal, this circumstance likely would have qualified as a "safe harbor" reason for a hardship withdrawal. Specifically, there is a safe harbor for "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)."<sup>1</sup> If the damage to the participant's principal residence from the hot water heater leak qualified for the casualty deduction under Code Section 165, then it is likely that the safe harbor would apply. Under IRS Publication 547, the deterioration and damage to a water heater that bursts is "progressive deterioration" that is not deductible as a casualty loss. However, the resulting water damage caused by the bursting of the water heater *does* qualify as a deductible casualty loss.<sup>2</sup> Note that, to be deductible under Code Section 165, a casualty loss must not be covered by insurance or some other source. As long as the repairs for the damage to the principal residence would qualify for the casualty deduction under Code Section 165, it should be a permitted "safe harbor" reason for a hardship withdrawal.

However, the Tax Cuts and Jobs Act of 2017 (TCJA) inadvertently created a glitch in the safe harbor regulations. Effective in 2018, the TCJA 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, and the loss must be attributable to events giving rise to a declaration of disaster area status. This created uncertainty around whether hardship withdrawals for repairs to a participant's principal residence would be permitted only if the principal residence was located in a federally-declared disaster zone. However, in November 2018, the IRS issued proposed regulations clarifying that the

TCJA changes to Code Section 165 do *not* apply to hardship withdrawals (i.e., a hardship withdrawal because of damages to a participant's principal residence does not need to be tied to a federally-declared disaster).<sup>3</sup> While this was welcome news to many 401(k) plan sponsors, following the issuance of the proposed regulations, there was further confusion, because the proposed regulations did not explicitly state in the preamble that taxpayers could rely on the proposed regulations until final regulations are issued. Many practitioners thought that it could be inferred that the proposed regulations could be relied upon pending the issuance of final regulations, but other practitioners felt that the absence of the usual language permitting reliance until the issuance of final regulations meant that this was not the case.

In early 2019, various organizations submitted comment letters on the proposed regulations asking the IRS to specifically issue guidance clarifying that plan sponsors may immediately rely on the proposed regulations prior to the issuance of final regulations. Recently, the IRS issued such a clarification, and has explicitly stated that “[t]axpayers may rely on the proposed regulations until the date of publication of final regulations in the Federal Register.”<sup>4</sup> This eliminated the uncertainty, and makes it clear that you can rely on the proposed regulations to take the position that there is no requirement that the repairs to the principal residence be related to a disaster in a federally declared disaster zone.

However, you will want to make sure to review the terms of your 401(k) plan document and that any action you take is in accordance with the terms of the plan (and, if necessary, make any plan amendments needed to comply with the proposed regulations). You will also want to ensure that you properly document the hardship withdrawal and follow the procedures set forth in the plan document and IRS

guidance to substantiate the participant's hardship.

### DOCUMENTATION IS REQUIRED TO SUBSTANTIATE A HARDSHIP WITHDRAWAL

**Q** We are reviewing our internal plan procedures and want to make sure we have procedures in place to document hardship withdrawals. What is the best way to document hardship withdrawals?

**A** The IRS Revenue Service has issued internal guidance on the steps that an IRS examiner must follow to verify adequate documentation of a hardship withdrawal. This internal guidance may be helpful to plan administrators to ensure that hardship withdrawals are properly substantiated. Under IRS internal guidance:

- 1) Before authorizing a hardship withdrawal under the safe harbor, an employer or third party administrator must review either (a) source documents, such as estimates, contracts, bills, and statements from third parties, or (b) a summary of the information contained in the source documents.
- 2) Where source documents are obtained, the employer or third party administrator must review the documents to determine if they substantiate the hardship withdrawal.
- 3) Where a summary of source documents is obtained instead of actual source documents, the employer or third party administrator must review the summary to determine whether it contains the following additional information:
  - Notifications to the employee (e.g., that the hardship withdrawal is taxable and additional taxes could apply, that the amount of the distribution cannot exceed the immediate and

heavy financial need, and that the recipient agrees to preserve source documents and make them available at any time, upon request, to the employer or administrator), general information (e.g., the total cost of the event causing the hardship, the amount of the distribution requested, and certification by the participant that the information provided is true and accurate), and specific information for each type of deemed hardship, as follows:

- For hardship withdrawals related to medical care, the summary should include the following additional information: the person who incurred the medical expenses, the person's relationship to the participant, the purpose of the medical care, the name and address of the service provider, and the amount of medical expenses not covered by insurance.
- For hardship withdrawals related to the purchase of a principal residence, the summary should include the following additional information: whether this will be the participant's principal residence, the address of the residence, the purchase price of the principal residence, types of costs and expenses covered, name and address of the lender, date of the purchase/sale agreement, and expected date of closing.
- For hardship withdrawals related to educational payments, the summary should include the following additional information: the person for whom the educational payments are made, what the relationship is to the participant, the name and address of the educational institution, categories of educational payments involved,

- and period covered by the educational payments.
- For hardship withdrawals related to foreclosure/eviction from the participant's principal residence, the summary should include the following additional information: whether this is the participant's principal residence, address of the residence, type of event (foreclosure or eviction), name and address of the party that issued the foreclosure or eviction notice, date of the notice of foreclosure or eviction, and due date of the payment to avoid foreclosure or eviction.
  - For hardship withdrawals related to funeral and burial expenses, the summary should include the following additional information: name of the deceased, relationship to the participant, date of death, and name and address of the service provider.
  - For hardship withdrawals related to repairs for damage to a participant's principal residence, the summary should include the following additional information: whether this is the participant's principal residence, the address of the residence that sustained the damage, a brief description of the cause of the casualty loss, including the date of the casualty loss, and a brief description of the repairs (including the date(s) of repair (in process or completed)).<sup>5</sup> 🌐

**NOTES**

1. Treas. Reg. §1.401(k)-1(d)(3)(iii)(B)(6).
2. See also Rev. Rul. 70-91, 1970-1 C.B. 37 and *Cooper v. Commissioner*, T.C. Summ. Op. 2003-168.

3. See Prop. Reg. 1.401(k)-1(d)(3)(iii)(B)(6), 83 Fed. Reg. 56763-56768.
4. See IRS 2019 Operational Compliance List.
5. See TE/GE-04-0217-0008, dated February 23, 2017, and Internal Revenue Manual 4.72.2.

Marjorie M. Glover, a partner in the New York City office of Norton Rose Fulbright US LLP, focuses her practice on executive compensation and employee benefits law, corporate governance and risk oversight and employment law. David Gallai, who also is a partner in the firm's New York City office, practices in the areas of employment counseling, executive compensation, and employee benefits. Rachel M. Kurth is a senior counsel at the firm. They can be reached at [marjorie.glover@nortonrosefulbright.com](mailto:marjorie.glover@nortonrosefulbright.com), [david.gallai@nortonrosefulbright.com](mailto:david.gallai@nortonrosefulbright.com), and [rachel.kurth@nortonrosefulbright.com](mailto:rachel.kurth@nortonrosefulbright.com), respectively.

Copyright © 2019 CCH Incorporated. All Rights Reserved.  
 Reprinted from *Employee Benefit Plan Review*, September 2019, Volume 73, Number 7,  
 pages 3–5, with permission from Wolters Kluwer, New York, NY,  
 1-800-638-8437, [www.WoltersKluwerLR.com](http://www.WoltersKluwerLR.com)

