August 2, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC  20220

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC  20224

Re: Hardship Distributions from Section 401(k) Plans and Section 403(b) Arrangements Resulting from Casualty Losses (Pub. L. No. 115-97, Sec. 11044(a))

Dear Messrs. Kautter and Paul:

The American Institute of CPAs (AICPA) respectfully requests that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) provide immediate guidance to correct the effect of the amendment of section 165 of the Internal Revenue Code (IRC or “Code”)1 by Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA), on the ability of section 401(k) plans and section 403(b) annuities to issue hardship distributions pursuant to the criteria of Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(6).2

BACKGROUND

Definition of “Casualty” under Section 165

Prior to the TCJA, per section 165 an individual was entitled to a personal casualty loss deduction for certain property damage caused by fire, storm, shipwreck, or other casualty,3 subject to the following criteria:

- Each casualty must exceed $100;4 and
- The total amount of casualty losses exceeds 10% of adjusted gross income.5

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1 Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.
2 Hardship distributions are also available to elective deferrals under 403(b) arrangements, using the same standards that apply to 401(k) plans.
3 IRC section 165(c)(3).
4 IRC section 165(h)(1).
5 IRC section 165(h)(2)(ii). In addition, the individual must itemize deductions.
The TCJA amended section 165 to narrow the definition of the term “casualty” for purposes of the casualty loss deduction. Under section 165(h), as amended, losses resulting from casualties from 2018 through 2025 are only deductible if the casualty occurs in a federally declared disaster area.\(^6\)

\textit{Hardship Distributions from Section 401(k) Plans}

Section 401(k) plans are permitted to distribute elective deferrals and related earnings to a participant who incurs a hardship. These hardship distributions are exceptions to the general rule that section 401(k) plans are generally not permitted to distribute a participant’s elective deferrals and related earnings prior to the earlier of the participant’s termination of employment, death, disability, attainment of age 59 ½ or termination of the plan.\(^7\)

The term “hardship” for purposes of hardship distributions is not defined in the statute. However, Treas. Reg. § 1.401(k)-1(d) provides detailed guidance on the criteria necessary to establish that a hardship has occurred in order to justify a distribution from a section 401(k) plan. Generally, a distribution qualifies as a hardship distribution if it satisfies the following two criteria:

- The distribution is made on account of an immediate and heavy financial need of the employee;
- The distribution is necessary to satisfy the financial need.

Treasury Reg. § 1.401(k)-1(d)(3)(iii)(B) includes safe harbors for satisfying these criteria, which most 401(k) plans use to remove subjectivity and uncertainty from plan administration. One of the criteria included in the safe harbors that is deemed to constitute an immediate and heavy financial need relates to “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).”\(^8\) Emphasis added.

\textit{Hardship Distributions from Section 403(b) Arrangements}

Section 403(b)(11) provides for the permissible distributable events for elective deferrals under section 403(b) arrangements. Specifically, section 403(b)(11)(B) permits distributions to plan participants who incur a hardship. The regulations under 403(b) provide that the term “hardship” for this purpose is defined using the hardship distribution rules applicable to deferrals under 401(k) plans.\(^9\)

Under the Code and regulations, the hardship rules apply specifically to elective deferrals. Other types of contributions to qualified plans and 403(b) arrangements are subject to different

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\(^6\) IRC section 165(h)(5).
\(^7\) IRC section 401(k)(2)(B)(i) and Treas. Reg. § 1.401(k)-1(d)(1)(iii).
\(^8\) IRC Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(6).
\(^9\) Treasury Reg. § 1.403(b)-6(d)(2).
distribution rules. For many of these contributions, the plan sponsor can provide the participant with in-service access to these funds without having first incurred a hardship. However, many plans are designed such that the hardship rules that must apply to 401(k) deferrals and 403(b) arrangements are extended to other types of contributions under the plan.

RECOMMENDATION

The AICPA recommends that Treasury and the IRS issue guidance permitting individuals who suffer a casualty loss that would have qualified under the rules of section 165(h) prior to their amendment by the TCJA, to continue to qualify for a hardship distribution from their 401(k) plan, as well as from elective deferrals made to a 403(b) arrangement.

There is no indication that Congress intended to restrict the hardship distributions from 401(k) plans or 403(b) arrangements when amendments were made to section 165. The IRS and Treasury are not required to connect hardship distributions from 401(k) plans or 403(b) arrangements to the criteria in section 165(h) as amended.

Therefore, we recommend that the IRS and Treasury define a casualty loss for purposes of the hardship distribution safe harbor by using a standard other than the standard under section 165 as amended by the TCJA. We also request that the IRS and Treasury permit hardship distributions to a plan participant who incurs a casualty loss based on the section 165(h) standards that existed prior to the amendment of section 165(h) by the TCJA.

ANALYSIS

Due to the specific reference to section 165 in Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(6) and the amendment to section 165 by the TCJA, the qualification criteria related to hardship distributions changed effective January 1, 2018 (and the change remains in effect through 2025). This change will require sponsors of 401(k) plans or 403(b) arrangements that have elective deferrals, who use the safe harbor criteria to define a hardship, to alter how they administer plans. Many plan sponsors should have made immediate changes to their plans’ administrative practice. However, some plan sponsors may not have revised their plans if they were unaware that the rules applicable in 2017 are no longer valid.

Plan participants who incur a hardship in a non-Federally declared disaster area no longer have access to their retirement funds via a hardship distribution to help defray the large, unexpected costs associated with a casualty loss. These plan participants should continue to have access to these funds in the same way that they were prior to the amendment of section 165 by the TCJA.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact Jeff Martin, Chair, AICPA Employee Benefits Taxation Technical Resource Panel, at (703) 946-4467, or Jeffrey.martin@us.gt.com; Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241 or Kristin.esposito@aicpa-cima.com; or me at (408) 924-3508 or Annette.Nellen@sjsu.edu.

Respectfully submitted,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Acting Commissioner, Internal Revenue Service
    Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
    Mr. Robert Neis, Benefits Tax Counsel, Department of the Treasury
    Mr. Stephen LaGarde, Attorney-Advisor, Office of Benefits Tax Counsel, Department of the Treasury
    Mr. Christopher W. Call, Attorney-Advisor (Tax Legislation), Office of Tax Policy, Department of the Treasury
    Ms. Veena Murthy, Legislation Counsel, Joint Committee on Taxation