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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:

CC:ITA:2 – GENIN-127233-04

Date:

September 13, 2004

Dear

In your letter of May 4, 2004, you requested a ruling that the cost of using a surrogate mother to bear your child would be allowed as an exception to the tax on early distributions from an individual retirement plan under § 401(k) of the Internal Revenue Code. You also requested a ruling that these expenses would be deductible under § 213 as medical expenses. Although you requested a formal ruling, you neither followed the procedures of Rev. Proc. 2004-1 to apply for a ruling nor enclosed the required user fee. Consequently, we cannot provide you with a ruling. However, I am happy to provide you with general information.

In your letter, you state that you participate in a plan subject to the requirements § 401(k) and that you intend to borrow money from the plan to cover the expenses associated with the use of a surrogate mother. Generally, distributions from a § 401(k) plan are not allowed before the occurrence of certain stated events, for example, retirement, death or disability. However, loans up to a certain dollar amount with certain repayment terms are not treated as taxable distributions from the plan. Therefore, the loan amounts are not taxable as income and are not subject to an early distribution penalty. You should consult your plan administrator to determine whether your plan offers a loan option.

Additionally, the plan may allow for “hardship distributions.” A hardship distribution has two basic requirements: (1) the distribution is made on account of an immediate and heavy financial need of the employee and (2) the distribution is necessary to satisfy the financial need. These two requirements are applied with reference to all of the relevant facts and circumstances. However, the plan may provide that the existence of certain facts will be deemed to satisfy the two hardship distribution requirements. An employee is deemed to have an immediate and heavy financial need with regard to expenses for medical care described in § 213(d). Similarly, a distribution is deemed to be necessary to satisfy the financial need if certain conditions are met. For example, the employee has obtained all distributions, other than hardship distributions, and all nontaxable loans currently available under all plans maintained by the employer. You should consult your plan administrator to determine whether your plan offers a hardship distribution option and whether you meet the hardship distribution criteria under the plan.

A hardship distribution is treated as a distribution from the plan. As such, a hardship distribution is includible in taxable income, subject to applicable withholding, and subject

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to a ten-percent additional tax on early distributions. The ten-percent early distribution tax does not apply to a distribution to the extent the amounts are for medical expenses deductible under § 213. However, hardship distributions that are not deductible under § 213 will be subject to the ten-percent tax.

Section 213(a) allows a taxpayer to deduct the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents (as defined in § 152), to the extent the expenses exceed 7.5 percent of adjusted gross income. Section 152(a) defines a dependent as an individual of a kind listed in the section, for whom the taxpayer provided over half of the support for the taxable year, and who meets several other requirements. Chapter 3, Personal Exemptions and Dependents, in Publication 17, *Your Federal Income Tax*, explains these requirements in greater detail. You can get a free copy of Publication 17 by calling 1-800-TAX FORM.

A surrogate mother is not the taxpayer or the taxpayer's spouse, and typically is not the type of relative listed in § 152(a). The surrogate mother usually is neither a member of the taxpayer's household for the entire taxable year, nor receives over half her support from the taxpayer for that year, and thus does not qualify as a non-relative dependent. Nor is an unborn child a dependent. *Cassman v. United States*, 31 Fed. Cl. 121 (1994). Thus, medical expenses paid for a surrogate mother and her unborn child generally would not qualify for deduction under § 213(a).

Under very limited circumstances, legal fees may be allowable as medical care expenses. In *Gerstacker v. Commissioner*, 414 F.2d 448 (6th Cir. 1969), legal expenses incurred to create a guardianship in order to involuntarily hospitalize a medically ill taxpayer were held to be deductible medical expenses because the medical treatment could not otherwise have occurred. However, legal expenses incurred in connection with a surrogate mother are typically not in connection with otherwise-deductible medical care expenses. Thus, the legal expenses likewise would not be deductible under § 213(a).

I hope this information is helpful. Please call _____ at _____ (not a toll-free call) if you have any questions.

Sincerely,

Thomas D. Moffitt
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)