When You Need Your Money Now: Hardship Withdrawals

Plans that permit hardship withdrawals during employment do so for specific purposes identified in your plan. The reasons that your 401(k) plan may allow you to receive a hardship withdrawal include:

- *Medical.* These costs include medical expenses for you, your spouse, or any dependents. Medical expenses that are deductible for income tax purposes are not subject to the additional 10 percent penalty on pre-retirement distributions.

- *Education.* You can withdraw money for post-high school expenses for the next 12 months. These costs include tuition, room and board, books, and other related expenses for you, your spouse, or any dependents.

- *Principal residence.* A withdrawal may be taken to use as a down payment on your principal home. Mortgage payments or secondary residences are not included. However, withdrawals are permitted to prevent eviction from your residence or foreclosure on your home and to repair casualty damage to your principal residence.

- *Burial or Funeral Expense.* These costs include burial or funeral expenses for your deceased parent, spouse, or any dependents.

- *Taxes and Penalties.* Any amounts needed to pay income taxes or penalties reasonably expected to result from the hardship distribution.

Your 401(k) plan administrator may require you to submit documentation showing that you have an immediate and heavy financial need as indicated above. In addition, the 401(k) plan most likely will impose the following requirements:

1. The amount distributed does not exceed the amount needed to satisfy the financial need,
2. You have already received any distributions and nontaxable loan available from your employer's plans, and
3. You will not be able to make any pre-tax contributions to the 401(k) plan for at least six months.

The decision to take a hardship withdrawal from your plan is a serious one with large tax costs and retirement security issues for you to consider. Please keep in mind the following:

- A hardship withdrawal is not a loan. Once the withdrawal is taken, these funds cannot be repaid to your plan account.

- A hardship withdrawal generally cannot be rolled over to your IRA or other type of retirement plan.

- If you take a hardship withdrawal before age 59 1N2, a 10 percent early withdrawal federal tax penalty will be imposed, in addition to income taxes on the amount withdrawn. Depending on your federal tax bracket and the tax rate of your state, you could pay taxes and penalties totaling as much as half of the distributed amount.

- Taxes will be withheld at distribution on any money you withdraw. By law, your plan will deduct and pay to the federal government twenty percent of the money you withdraw. When you file your next tax return, you will receive credit for the taxes withheld from the distribution. However, you will most likely owe additional taxes and penalties on the amount withdrawn. And, since your taxable income will increase due to the hardship withdrawal, you may owe higher taxes on your other income due to phase out limits and higher tax brackets. Assuming you spent the money on the hardship event, you will need to pay these taxes and penalties from other assets you have accumulated.

- If you take a hardship withdrawal, you may be prohibited from making contributions to your plan for a period of time, thus losing the opportunity to save pretax money or receive your employer's match during that time.

Hardship withdrawals come with serious penalties to discourage you from taking money out. Figure 5.1 presents an example of the penalties and taxes you will owe if you take a hardship withdrawal. Your hardship has to be pretty hard to make it worth all this trouble. When your financial problem is that serious, you must also determine if it meets the hardship specifications and whether you have other sources of funds that would better finance your needs.

Figure 5.1: Tax and Penalty Impact of Hardship Withdrawl

Pat is under age 59 1/2 and decides to take a $25,000 hardship withdrawal from the 401(k) plan. Pat's marginal tax rate for federal and state income tax is 33%. Pat will receive an initial distribution of $20,000, because a 20% federal income tax withholding of $5,000 will be made at the time of the distribution.
Because he is under age 591K2 , he must pay the 10% early withdrawal penalty of $2,500 and the combined federal and state income tax of $8,250.The taxes will be paid in two installments with the 20% federal income tax withholding of $5,000 at the time of the distribution and the remaining combined taxes of $3,250 due with his next income tax filing.The amount of the distribution available to Pat will be reduced from $25,000 to $14,250 after taxes and penalties are paid.

Amount of Distribution Requested	$25,000
20% Mandatory Federal Withholding	$5,000
Initial Distribution Made to Pat	$20,000
10% Early Withdrawl Penalty	$2,500
Additional Federal and State Income Taxes	$3,250
Amount of Distribution Made to Pat	$14,250