

BUILDING BLOCKS FOR RETIREMENT

Distribution Planning

Understanding Hardship Withdrawals

What Is A Hardship Withdrawal?

Generally speaking, a hardship withdrawal is a distribution that may be permitted from your retirement plan to address an immediate and serious financial need. If your plan allows hardship withdrawals, the plan document should define a “hardship” in objective terms.

What Types Of Retirement Plans Permit Hardship Withdrawals?

Typically, most 401(k) plans permit hardship withdrawals. Other types of retirement plans may permit them as well. Refer to your Summary Plan Description (SPD) or check with your human resources department to determine if your plan allows hardship withdrawals.



Who Is Eligible For Hardship Withdrawals?

In order to be eligible to take a hardship withdrawal, you must first demonstrate that your circumstances meet your plan's definition of a hardship. You must then demonstrate that your immediate and heavy financial need cannot be relieved by other sources.

What Is The IRS Definition Of Hardship?

Most plans use the IRS safe harbor definition of hardship. Under the safe harbor definition, a distribution is deemed to be for an immediate and heavy financial need if it is made for any one or combination of the following reasons:

- Unreimbursed medical expenses¹
- Costs relating to the purchase of a principal residence
- Tuition and related fees and expenses for post-secondary education
- Payments necessary to prevent eviction from, or foreclosure on, a principal residence
- Burial or funeral expenses
- Certain expenses for the repair of damage to your principal residence²

Your retirement plan may permit hardship distributions for reasons other than those mentioned above.

¹ The medical expenses must be of the type that would be deductible under Internal Revenue Code (IRC) Section 213(d).

² The expense must be of the type that would qualify for the casualty deduction under IRC Section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

How Is It Demonstrated That the Hardship Distribution Is Necessary To Satisfy The Financial Need?

This requirement is satisfied either under a facts and circumstances test or under a safe harbor test, as specified in your plan. Under the facts and circumstances test, all relevant factors are considered to determine whether you have other resources reasonably available to relieve the need. These factors include reimbursement or compensation by insurance, liquidation of your assets, cessation of deferrals to the plan, currently available distributions or nontaxable loans from your plans, and borrowing from commercial sources on reasonable commercial terms. Your employer can rely upon your written representation that the need cannot be satisfied from these sources, unless the employer has actual knowledge to the contrary.

Under the IRS safe harbor test, the distribution is deemed necessary to satisfy the financial need if the distribution does not exceed the amount of the financial need, you have received all currently available loans and other distributions from the plan and any other plan maintained by the employer, and the plan suspends you from making deferrals or contributions for at least six months. A plan that uses the safe harbor definition of a hardship can use a facts and circumstances approach to determine financial need, so it is important to speak with your human resources representative and understand the requirements of your plan.

What Is the Maximum Amount That Can Be Distributed?

A hardship distribution may not exceed the amount of your financial need. However, the amount required to satisfy the financial need may include amounts necessary to pay any taxes or penalties that may result from the distribution.

The amount of elective contributions available for a hardship distribution cannot be more than the amount of your total elective contributions, including designated Roth contributions, as of the date of distribution, reduced by the amount of previous distributions of elective contributions.

This "maximum distributable amount" generally does not include earnings, qualified non-elective contributions or qualified matching contributions, unless the plan provides that certain grandfathered amounts are included.

Other amounts under the plan, if any, such as regular matching contributions and discretionary profit-sharing contributions may also be distributed on account of hardship if the plan so provides. A Pentegra customer service representative can provide you with an estimate of the amount that is currently available for a hardship distribution.

NOTE: The actual withdrawal amount will be recalculated on the day of the actual distribution.

What Are the Tax Consequences?

A hardship distribution from your retirement savings plan is generally taxable at your ordinary income tax rate.³ You will receive an IRS Form 1099-R for the year in which the distribution occurs.⁴ In addition to regular taxes, you also may have to pay a 10% early withdrawal penalty on the distribution if you haven't reached age 59½. (Exceptions apply.) Added together, taxes and the penalty could result in you receiving a net amount that is less than you had anticipated.

³ Qualified distributions from a designated Roth account are not taxable.

⁴ Accordingly, the distribution is reportable and must be taken into account when you prepare your income tax return.

Currently, service providers are required to withhold 10% from your distribution for federal income taxes, unless you elect not to have such taxes withheld. Accordingly, if you request a hardship distribution of \$5,000 and would prefer to address tax issues at a later time, you could elect NOT to have taxes withheld and receive a check for the full \$5,000.



As mentioned earlier, you also may elect to have your distribution “grossed up” for anticipated taxes on the distribution, provided the total amount does not exceed your maximum available hardship withdrawal amount.

For example, suppose you requested that the hardship amount be grossed up by 10% to offset the 10% excise tax on premature distributions. Assume your hardship need is \$10,000, the 10% penalty would be \$1,000. You can request a withdrawal of \$11,000. This assumes you have \$11,000 or more available for a hardship distribution.

What Documentation Must Be Provided to Demonstrate A Hardship?

As a preliminary matter, an immediate and heavy financial need exists if you do not have the resources to pay the particular bill. The financial need no longer exists if the bill was paid. Therefore the documentation submitted as proof of hardship should not indicate that the expense has already been paid (even if paid by a family member or friend as a “loan”). For example, a paid tuition bill, or copies of medical bills indicating a balance paid, will automatically disqualify the hardship. The bill cannot be submitted for reimbursement of amounts previously paid.

The following are examples of documentation for specific types of hardships:

- **Medical expenses** - Unpaid medical bills or a copy of the insurance statement indicating the patient portion of the expense for you, your spouse or dependents. If the documentation is dated more than three months earlier, the plan may request a more recent statement to confirm the amount remains outstanding.
- **Principal residence** - A copy of the contract of sale signed by both parties and the mortgage application for your purchase of a primary residence. The financial section of the mortgage application indicating the amount due at closing must be provided.
- **Tuition and room and board** - A copy of an unpaid tuition bill for post-secondary education for up to the next 12 months for you, your spouse or dependents.
- **Prevention of eviction or foreclosure from a participant's principal residence** - An actual legal notice of eviction, notice of foreclosure or evidence showing the commencement of legal action, including the dollar amount necessary in order to prevent eviction or foreclosure. The notice must indicate you are being threatened with actual eviction or foreclosure. Paperwork simply indicating that you are behind in your payments will be denied.
- **Burial or funeral expenses** - A copy of the death certificate (of a spouse, parents, children or dependents) and a bill detailing the cost of the funeral, burial or cremation.

- **Repair of damages to the participant's principal residence that would qualify for the casualty deduction** - An estimate or bill for repairs and proof that insurance proceeds did not cover the amount of the expense claimed. To qualify, the destruction or loss of property must have resulted from an identifiable event that is sudden, unexpected or unusual (e.g., damages from a hurricane or flood). Expenses for damages resulting from progressive deterioration or for routine maintenance would not qualify.

What Is The Hardship Withdrawal Process?

You must complete a hardship withdrawal form. This form should be submitted to the plan administrator along with documentation supporting the amount of the hardship request. After review, if more documentation is required in order to approve the hardship, you will be contacted and more information will be requested. If the amount available to you is less than the amount requested, you will also be contacted and the amount of the approved hardship will be communicated. Once the hardship is approved, your request will be processed within 2-5 business days.

Consider Other Options First

Keep in mind that withdrawing money from your 401(k) plan—even if it's a small amount—robs you of the potential for time and compounding to turn your savings into a significant nest egg. As explained above, withdrawing the money also means you'll owe federal income taxes on the amount withdrawn. In addition, your distribution may also be subject to state income taxes and/or a 10% premature withdrawal penalty.

For more information, contact the Pentegra Customer Service Center at customerservice@pentegra.com or 866-633-4015.

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