HARDSHIP WITHDRAWALS: WHAT YOU NEED TO KNOW

When finances are tight or a large expense is looming, many people think of tapping into their retirement savings. A hardship withdrawal can seem like a good way to meet immediate needs, but there are a number of very good reasons that it should be an option of last resort. Following are some facts and consequences you should take into consideration before applying for one.

ALTERNATIVES TO CONSIDER

A Loan:
If available under your plan, plan loans offer advantages:

- They are not subject to taxes or penalties[1]
- You can continue to contribute to the plan while you repay the loan.

Withdrawal from IRA Savings:
If you have IRA savings, IRS rules allow the following penalty-free withdrawals:

- Up to $10,000 when the money is used for qualified first home expenses. (This is a lifetime limit.)
- When the savings are used to pay for qualified higher education expenses for you or your spouse, children or grandchildren.

WHY THEY WERE CREATED AND WHAT THEY ARE FOR...

When creating the legislation governing retirement investments, Congress understood that you might be less willing to put money away for retirement if you knew you'd be completely restricted from accessing it, even if you had an emergency and had no other resources. So, they included rules that would allow you to access your retirement funds in certain circumstances. The IRS considers the following to be acceptable reasons for a "hardship withdrawal":

1. Un-reimbursed medical expenses for you, your spouse, or dependents.
2. Purchase of your principal residence.
3. Payment of college tuition and related educational costs, such as room and board for the next 12 months for you, your spouse, dependents, or children who are no longer dependents.
4. Payments necessary to prevent you from being evicted from your home, or the mortgage on your principal residence from being foreclosed.
5. Funeral expenses.
6. Certain expenses for the repair of damage to your principal residence.

If you find yourself in any of these situations and have no other way to make ends meet, then a hardship withdrawal may be the solution. However, before you act, be sure to take the following into account.

[1] If you leave your employer before the loan is repaid, you may be required to pay back the remaining balance, otherwise it will be considered a withdrawal and subject to applicable taxes and penalties.

Likewise, if you default on the loan, you will be taxed on the outstanding loan balance and may not be entitled to another loan.

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CONSEQUENCE #1: TAX PAIN AND POTENTIAL PENALTIES

First off, you will have to pay income tax on your withdrawal. In addition to that, the IRS often imposes a hefty financial penalty to discourage early withdrawals. This can include a 10 percent early-withdrawal penalty if you are younger than 59½.

What that means for you: A $10,000 withdrawal does not equal $10,000 in your pocket. If you are under 59½, you will lose 35 percent to 45 percent of the withdrawal in taxes and penalties, depending on your tax bracket. For example, suppose you fall in the 28 percent tax bracket: If you take a $10,000 hardship withdrawal to pay for your child's college tuition, you will owe $2,800 in federal income taxes and an additional $1,000 to cover the early withdrawal penalty. You'll be left with $6,300, or even less if you also owe state and local income tax.

Exceptions to the Early Withdrawal Penalty: You still will have to pay income taxes but may qualify to take a penalty-free withdrawal if you are:

- Totally disabled.
- In debt for medical expenses that exceed 7.5 percent of your adjusted gross income.
- Required by court order to give the money to your divorced spouse, a child, or a dependent.
- Separated from service (through permanent layoff, termination, quitting or taking early retirement) in the year you turn 55, or later.
- Separated from service and you have set up a payment schedule to withdraw money in substantially equal amounts over the course of your life expectancy. (Once you begin taking this kind of distribution you are required to continue for five years or until you reach age 59½, whichever is longer.)
- Qualified Reservist distributions.

CONSEQUENCE #2: LONG-TERM IMPACT ON YOUR RETIREMENT SAVINGS

Unlike a loan, once you take the hardship withdrawal out of your plan, you generally can't repay it to the plan.

What that means for you: You lose—for life—the tax advantage and potential growth on the funds you withdraw. And, that can mean a big difference to what you will have at retirement. For illustrative purposes, let's take the example of a person who, starting at age 30, contributes $5,000 a year to her retirement plan. At age 40, she takes a $10,000 hardship withdrawal for the down payment on a house. If her portfolio generates an average annual return of 8 percent, by retirement at age 65, she will have $793,094. However, if she hadn't taken the hardship withdrawal, she would have had $861,584! That $10,000 withdrawal meant $68,490 less in retirement.

Additionally, if your plan uses the safe-harbor method of determining eligibility for hardship withdrawals, you will not be allowed to make another retirement contribution to your plan for at least six months after taking the withdrawal. This further limits your ability to build a retirement nest egg.

For further information about hardship withdrawals under your employer's plan, or to request application forms or information about other alternatives available under the plan, please contact your benefits office.

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