What You Need to Know about Hardship Withdrawals

Plan participants encountering financial difficulties may be wondering if they should, or even can, access retirement plan savings. Considering one's retirement account as a place to get emergency cash may be necessary. A last-resort option to consider may be a Hardship Withdrawal.

What is a "hardship withdrawal"?

A hardship withdrawal is an optional plan provision that allows a plan participant to make a withdrawal of retirement funds upon proof of certain financial hardships. You, as the plan administrator, decide whether an individual plan participant's circumstances meet the plan's requirements to qualify for a hardship withdrawal. There are different ways to structure a hardship provision under a retirement plan, but many plans use the safe harbor rules found in Treasury regulations. These rules are described below.

What conditions must be met to determine if a hardship withdrawal may be an option?

1. The withdrawal is necessary due to an immediate and heavy financial need.
2. The withdrawal is necessary to satisfy that need (i.e., the participant can't get the money elsewhere).
3. The net amount of the withdrawal does not exceed the amount of the need.
4. The participant has already exhausted or considered the loan option available under your retirement plan.

   If the effect of using one of the resources listed above results in a greater need, it would not be reasonable to first exhaust that resource. For example, according to the Internal Revenue Service (IRS), if a participant needs funds to purchase a primary residence and taking a loan from the plan would disqualify the participant from obtaining other necessary financing, it would not be reasonable for the participant to take a plan loan. However, recent IRS guidance has emphasized that in most cases loans need to be taken first.

Under the deemed safe harbor rules, what reasons qualify for a hardship withdrawal?

If conditions above are met, funds can be withdrawn and used for the following reasons:

- Unreimbursed medical expenses incurred or necessary for medical care described under the Internal Revenue Code (IRC) for the participant, the participant's spouse or dependents
- Purchase (excluding mortgage payments) of a participant's principal residence
- Payment of college tuition and related educational costs such as room and board for the next 12 months for the participant, the participant's spouse, dependents or children who are no longer dependents
- Payments necessary to prevent eviction from the participant's residence, or foreclosure on the mortgage on the participant's principal residence
- For burial or funeral expenses for the participant's deceased parent, spouse, children or dependents.
- Certain expenses for the repair of damage to the participant's principal residence that would qualify for a casualty deduction under the IRC

What are my responsibilities as a plan sponsor?

You, as the Plan Administrator, are responsible for determining that a request meets the plan's hardship withdrawal requirements and approving the amount of withdrawal. Your written plan may specify the documentation needed to support a hardship withdrawal. If not, you should establish written procedures for making this determination. It is important for you to keep a record of all information used to determine approval of hardship and the amount of the hardship distribution. Please be aware that your plan may have some different policies, so be sure to contact your Service Associate for more plan-specific information.

What are the general guidelines for proof?

- Proof of need should be in writing.
- Proof should generally be provided in the form of legal documents, bills from identifiable businesses, etc. They should typically not be casual handwritten notes that cannot be established as legitimate.
- It is important to be able to identify the amount of the claimed need. The total amount should be itemized so that amounts that do not qualify can be subtracted to determine the need.

What documentation could be considered acceptable proof?

You and your attorney should establish written guidelines that specify the documentation to be used to demonstrate a hardship need under your plan. Reasonable documentation might include some or all of the following items.

Burial or Funeral Expenses: Evidence would generally include a bill from a funeral home showing the costs of the funeral or burial. Other possibilities might include a copy of the death certificate and/or proof of dependency.

Payments to Prevent Eviction or Foreclosure: Evidence would typically require an eviction or foreclosure notice. Typically this document will state that if the rent or overdue payment is not made by a specific date, eviction or foreclosure proceedings will commence.

Repair of Damage to Principal Residence: Evidence might include a description of the event that caused the damage, a repair bill and evidence that insurance did not cover the amount requested.

Purchase of a Principal Residence: Evidence could include a signed real estate contract or purchase agreement.

Unreimbursed Medical Care Expenses: Evidence could include an itemized bill from the hospital, doctor, dentist or other health care provider, plus evidence that the insurance did not cover the amount billed.

What are considered deductible medical expenses?

Medical expenses are the costs of diagnosis, cure, mitigation, treatment or prevention of disease, and the costs for treatments affecting any part or function of the body. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes. They also include dental expenses.

Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. They do not include expenses that are merely beneficial to general health, such as vitamins or a vacation.

Medical expenses include the premiums you pay for insurance that cover the expenses of medical care and the amounts you pay for transportation to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract.

Hardship withdrawals are available for medical expenses that would be deductible under Section 213(d) of the IRC. Examples of deductible and non-deductible medical expenses are shown below. Additional information is available in Publication 502, available at IRS.gov.

The following are examples of deductible medical expenses

Deductible Medical Expenses		
Abortion	Eye exams	Nursing home
Acupuncture	Eye surgery including laser and radial keratotomy	Nursing services
Alcoholism treatment	Eyeglasses for medical reasons	Operations
Ambulance service	Fertility enhancement	Oxygen
Artificial limb	Guide dog or service animal	Physical exam
Artificial teeth	Health institute treatment	Pregnancy test kit
Autoette	Hearing aids	Psychiatric care
Bandages	HMO premiums	Psychoanalysis
Birth control pills	Home for developmentally disabled	Special education
Body scan	Hospital services	Sterilization
Braille books and magazines	Insurance premiums (medical)	Stop-smoking programs
Breast reconstruction surgery	Lab fees	Telephone (hearing impaired)
Capital expenses (medically necessary)	Lead-based paint removal	Television (hearing impaired)
Car (special equipment or design)	Legal fees (related to mental illness)	Therapy
Chiropractor	Lifetime care	Transplants
Christian Science Practitioner	Lodging (related to medical care)	Transportation for medical care
Contact lenses for medical reasons	Long-term care	Vasectomy
Crutches	Meals (related to medical care)	Weight-loss program (disease-related)
Dental Treatment	Medical conferences	Wheelchair
Diagnostic devices	Medical information plan	Wig (disease-related hair loss)
Disabled dependent care expenses	Medical services (provider charges)	X-ray
Drug addiction treatment	Medicines (prescribed and insulin)	

The following are examples of non-deductible medical expenses

Non-deductible Medical Expenses		
Baby-sitting and child care	Future medical care	Medical savings account
Controlled substances	Hair transplant	Non-prescription drugs
Cosmetic surgery (unnecessary)	Health club dues	Nutritional supplements
Dancing lessons	Health coverage tax credit	Personal use items
Diaper service (unless disease-related)	Health savings accounts	Swimming lessons
Electrolysis or hair removal	Household help	Teeth whitening
Flexible Spending Account reimbursements	Illegal operations and treatments	Veterinary fees
Foreign medicines	Insurance premiums (life, disability, loss of limbs or sight)	Weight-loss program (not related to disease)
Funeral expenses	Maternity clothes	

For additional information on deductible medical expenses, refer to IRS Publication 502 (Medical and Dental Expenses, including the Health Coverage Tax Credit), available at IRS.gov.

What is the definition of "casualty"?

A casualty, according to the IRC, is the *"…damage, destruction, or loss of property resulting from an* ***identifiable event*** *that is sudden, unexpected, or unusual.*

- *A sudden event is one that is swift, not gradual or progressive.*
- *An unexpected event is one that is ordinarily unanticipated and unintended.*
- *An unusual event is one that is not a day-to-day occurrence and is not typical of the activity in which you were engaged."*

Treasury regulations specify that a loss must be *"…evidenced by closed end completed transactions, fixed by identifiable events, and…actually sustained during the taxable year."*

Source: Treasury Regulation 1.165-1(b)

Examples of deductible casualty losses that qualify for hardship:

Car accidents (but see below)	Demolition or relocation of home ordered by government because of disaster	Earthquakes
Fires (but see below)	Floods	Hurricanes
Mine cave-ins	Shipwrecks	Sonic booms
Storms	Tornadoes	Terrorist attacks
Vandalism	Volcanic eruptions	

Examples of non-deductible losses that would not qualify for hardship:

A casualty loss is not deductible if the damage or destruction is caused by the following:

- Accidentally breaking articles such as glassware or china under normal circumstances
- A family pet
- A fire if you willfully set it, or pay someone else to set it
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence or someone acting for you caused the accident.

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steady operating cause or a normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration:

- The steady weakening of a building due to normal wind and weather conditions.
- The water heater that bursts. However, the rust and water damage to the rugs and drapes caused by the bursting of a water heater does qualify as a casualty.
- Most losses of property caused by droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.
- Termite or moth damage.
- The damage or destruction of trees, shrubs or other plants by a fungus, disease, insects, worms or similar pests. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

For additional information refer to IRS Publication 547 (Casualties, Disasters and Thefts) available at IRS.gov.

Who is a "dependent" for income tax purposes?

Hardship withdrawals are available for certain hardships that result from expenses which apply to dependents of the participant. Three of the allowable hardship reasons potentially can involve expenses due to dependents – medical expenses, tuition expenses and funeral expenses.

The IRC defines a dependent as:

1. a qualifying child; or
2. a qualifying relative.

Qualifying Child

A qualifying child is:

- A child of the participant or a descendant of such child, *or*
- A brother, sister, stepbrother or stepsister of the participant or a descendant of any such relative, *and*
- Who lives with the participant for more than one-half of the year, *and*
- Has not attained age 19 as of the close of the year or is a student and has not attained age 24 as of the close of the year, *and*
- Has not provided over one-half of his or her own support for the year, *and*
- Has not filed a joint tax return with his or her spouse for the year.

Qualifying Relative

A qualifying relative is:

- A child or a descendant of a child of the participant, *or*
- A brother, sister, stepbrother or stepsister of the participant, *or*
- The father or mother of the participant, or an ancestor of either, *or*
- A stepfather or stepmother, *or*
- A son or daughter of a brother or sister of the participant, *or*
- A brother or sister of the father or mother of the participant, *or*
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law, *or*
- Other member of the participant's household, *and*
- The participant provides over one-half of the individual's support for the year, *and*
- The individual is not a qualifying child of the participant or anyone else for the year.

What are the consequences to taking a hardship withdrawal?

Although this may be the only option for some, the following are consequences for a participant to consider before taking this type of withdrawal.

- Taxation – Hardship withdrawals of pre-tax contributions are subject to state and federal taxes. In addition, in most cases it is subject to a 10% IRS penalty if the participant is younger than age 59½. One may qualify to take a penalty-free withdrawal if certain exceptions are met.
- Deferral Suspension - Elective deferrals and other participant contributions must be suspended for a six-month period after the hardship withdrawal has been taken. Thus, the participant loses the ability to make contributions to the plan plus any associated match contributions.
- Taking a hardship withdrawal can also result in a less generous account balance at retirement.

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