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The 5 Step Guide to Obtaining a Hardship Withdrawal – Read All the Steps Before Implementing The Strategy

If you have debt and you are in a situation of hardship, you can withdraw up to $10,000 penalty free from your 401K or IRA plan. (Note that the rules are different for SIMPLE IRAs, Profit Sharing Plans, or other types of pension plans – if you have one of these other types of plans, there may be more restrictions on what is available.) You will still be paying the income taxes however, so this should only be done if there are no other choices, or if loans are hard to come by.

Step 1)

Determine whether your need qualifies as a hardship situation:

This withdrawal exists for amounts of up to $10,000, which exists for hardship situations. What is a hardship situation? Your financial need would have to be "**immediate and heavy**" and "limited to the **amount necessary** to satisfy that financial need". Examples that qualify would be:

Medical Care for you, your spouse, dependents or beneficiaries
Principal Residence costs (but not mortgage payments)
Tuition and Room and Board for 12 months for you, your spouse, dependents or beneficiaries
Payments to prevent eviction or foreclosure
Funeral Expenses for you, your spouse, dependents or beneficiaries
Repair of Damage to Principal Residence

Note that an immediate and heavy need does not mean that it has to be unexpected. You could have seen the expense coming and not able to pay for it. You may also have voluntarily created the expense knowing that it may be difficult to pay for because it was necessary. See IRS Link below:

http://www.irs.gov/retirement/participant/article/0,,id=211439,00.html

The amount being "limited to the amount necessary" means that if you need $5,000 to pay for this immediate and heavy expense, you cannot withdraw $10,000. You can only withdraw $5,000 because it is enough to satisfy your need. If you need $5,000, but using a hardship withdrawal or distribution incurs a total bill of $7,000 including taxes and penalties, you can assume that your hardship withdrawal would in fact be $7,000 instead of $5,000. You must also show that you cannot obtain the money from other places, like insurance, selling assets, your pay check, borrowing from your IRA/401K or another type of loan. For a hardship withdrawal, the money is not paid back to the IRA/401K plan so it is not actually a loan. For the employer or IRA/401K plan sponsor, having a written statement identifying that you cannot obtain money from any other source would be enough evidence to prove your financial need, unless the employer can prove otherwise. If you have another means of obtaining money, but it adds to your financial need, or makes it more expensive, then this would not be considered a viable alternative, and you would be eligible for this hardship withdrawal.

Step 2)

Can you prove to the IRS and your employer that you have a hardship situation?

You would have to specify to the IRS and your employer what the situation is and they would have to approve it.

What documentation you should have will vary according to each situation. You should be able to prove to a third party what your financial condition is and show that there is no other way to make the payments. The best documentation would come from the government, IRS (tax returns or correspondence), insurance companies, your bank, your employer, or your hospital/doctor if applicable. If you have any written letters, appraisals, emails or any other statements relating to your situation, these would be useful as well as proof of backing up your claims.

One way to go about building proof is to construct a timeline from when your situation started to where it is at present, and back up each fact in your story with a document. As an example, you were assessed with this medical condition in January 2006, and this is the doctor's assessment showing this. The insurance company began to pay benefits for this condition starting in 2007, and here are their proofs of payment. I declared a disability from my employer and following are their documents. I declared this as income, and here are my tax returns to show where this income is. As you build your story or case, it will be very easy to demonstrate how you got to where you are today. If you have investigated any alternatives, show the correspondence or the results to prove that you indeed did everything you could, and you are genuine in your request.

Step 3)

What are the tax consequences to obtaining hardship money?

The first thing to consider is your age. If you are **under** the age of 59½, you are generally taxed at 10% for withdrawing the money plus whatever tax rate you would be paying on your income at that time. This situation is called an "early withdrawal" or "early redemption" in the tax code.

If you are **over** the age of 59½, you are exempt from the 10% withdrawal penalty, but you would still be paying income taxes at whatever your income tax rate is at the time of the withdrawal. If you are close to age 59½, it may be worth it to wait on your withdrawal if possible until you reach the age of 59½ and avoid this penalty, which could make the withdrawal an ordinary withdrawal rather than a hardship withdrawal. This may give you more flexibility in how you can use the money or pay it back, as well as save you on taxes.

The exceptions to the 10% tax rate on withdrawals are listed below:

1) They receive a distribution from a retirement plan (other than an IRA) after leaving a job and are age 55 (age 50 for qualified public safety employees).
2) They have unreimbursed medical expenses that are more than 7.5% of their adjusted gross income.
3) The distributions are not more than the cost of their medical insurance (IRA only).
4) They are disabled.
5) They are a beneficiary of a deceased plan participant or IRA owner.
6) They are receiving distributions in the form of an annuity.
7) The distributions are not more than their qualified higher education expenses (IRA only).
8) They use the distributions to buy, build or rebuild a first home (IRA only, and limited to $10,000).
9) The distribution is due to an IRS levy.
10) The distribution is a qualified reservist distribution.
11) The distribution is made to an alternate payee under a QDRO.
12) They are receiving a distribution timely made to reduce excess contributions under a 401(k) plan.
13) They are receiving a distribution timely made to reduce excess employee or matching employer contributions (excess aggregate contributions).
14) They are receiving a distribution timely made to reduce excess elective deferrals.
15) They are receiving a permissible withdrawal from an EACA.

Source: IRS Link
http://www.irs.gov/retirement/participant/article/0,,id=211440,00.html

With respect to the hardship withdrawals, bullets 2) and 3) relate to medical expenses, bullet 4) means that disability would be eligible, bullet 5) may relate to funeral expenses, bullet 7) relates to education, and bullet 8) relates to purchase a first home or rebuilding a principal residence. Most of the exceptions are present with IRA accounts, but not 401K accounts, so where the money is coming from is important in terms of whether you will pay the early withdrawal tax or not.

In terms of “Where am I taking the money from?” the 401K and the IRA have different rules depending on what the hardship scenario is. Any other plans like SIMPLE IRAs or employer profit sharing plans may have different restrictions and you should consult your employer, your accountant and the IRS tax code for details.

http://www.irs.gov/retirement/participant/article/0,,id=211440,00.html

Step 4)

Does my employer allow hardship distributions and what are the rules and restrictions?

When you take out a hardship withdrawal, your employer will stop contributing money to your 401K plan for a period which would normally be at least 6 months. This is money that you will not receive as a result, so this is an additional cost of the loan. Some employers will allow hardship withdrawals only under conditions, and some plans will not allow these types of withdrawals, so each individual situation would have to be assessed by your employer.

Step 5)

What are some other considerations?

If you are incurring this withdrawal to buy a house, take note that house prices may go down after you purchase your house. This may or may not affect your situation over a short period of time, but this scenario should be visited with respect to your home equity, and other existing debt that may be tied to your home. If you have absolutely no buffer from additional costs to own a home, this withdrawal may carry too much risk if it is insufficient to cover future expenses and your house is foreclosed on prematurely. This idea can be applied to all the hardship situations - what happens after the hardship withdrawal money runs out will have to be thought through.

Sources:

The rules for a hardship withdrawal are explained at the link below.

http://www.ehow.com/how_4830976_mortgage-foreclosure-k-hardship-withdrawal.html

These rules should be discussed with a tax advisor or your accountant. If you do not know where to start, see this link below.

http://www.justanswer.com/tax/5va0l-recently-took-hardship-withdrawal-401k.html

Hardship withdrawal and home ownership:

http://www.ehow.com/info_7742641_use-401k-savings-buy-house.html

IRS Web Sites:

Hardship Withdrawals

http://www.irs.gov/retirement/participant/article/0,,id=211439,00.html

Hardship withdrawals and 401K plans

http://www.irs.gov/retirement/article/0,,id=162416,00.html

IRAs

http://www.irs.gov/retirement/article/0,,id=111413,00.html

Early Distribution rules and exemptions:

http://www.irs.gov/retirement/participant/article/0,,id=211440,00.html

If you need specific information for your needs, contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This article is intended for people who want to learn about the world of finance and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**