Why is it so Hard to take a Hardship Withdrawal?

Plan Sponsors may offer hardship withdrawal provisions as part of their 401(k) plan. This design feature is optional. These provisions allow an employee to withdraw money from their account for reasons set forth by the IRS as immediate and heavy financial needs. While sponsors have some flexibility regarding the definition of what a financial hardship is, most plans use the safe harbor definitions provided in regulations.

Under the IRS safe harbor rules, a distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

- Costs directly related to the purchase of a principle residence for the employee (excluding mortgage payments);
- Unreimbursed medical expenses;
- Payments of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, spouse, children or dependents;
- Payments to prevent the eviction of the employee from the employee's principal residence of foreclosure on the mortgage on that residence;
- Payments for burial or funeral expenses for the employee's deceased parents, spouse children or dependents; or
- Expenses for the repair of damage to the employee's principle residence that would qualify for a casualty deduction(one time natural disaster)

Before an employee may request a financial hardship withdrawal, they must first attempt to relive the immediate and heavy financial need through other available resources. These resources include, but are not limited to, reimbursement from insurance, liquidation of assets, and borrowing from commercial sources. Participants are also required to obtain a loan through the loan provision of the 401(k) plan, if available. If the plan does not have a loan provision, or the participant already has an outstanding loan, the participant may be pursue a financial hardship withdrawal. Some plans require a paper application and associated documentation as proof of the need while others provide the ability to certify the financial need online.

To discourage the early withdrawal of retirement savings, the IRS imposes sever consequences. Hardship withdrawals are taxed at both the federal and state levels. Additionally, a penalty is applied to the amount withdrawn if the participants is under the age of 59 ½ (with certain specific exceptions). The retirement savings process is further impeded by the requirement that participants are prohibited from contributing to the 401(k) plan for six months following the hardship withdrawal.

Because hardship withdrawals can significantly impact the ability of participants to reach their retirement goals, we encourage you to discuss the pros and cons of the prolonged and tepid economic recovery.