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RAISING CASH IN TOUGH TIMES; SHOULD YOU CONSIDER A 401 (k) HARDSHIP DISTRIBUTION?

U.S. Tax Expert from Thomson Reuters Explores Your Options

New York, NY July 18, 2008 — The ongoing housing and mortgage market mess, struggling stock market and uncertain economic climate, mean tough times for cash-strapped individuals who have to raise money for an immediate financial need. “Compounding the misery is the fact that many people have locked away the lion’s share of their savings in a tax-favored retirement vehicle, like a company profit-sharing or 401(k) plan, IRA, SEP, SIMPLE IRA, or Roth IRA,” says Dick O’Donnell, Senior Tax Analyst from the Tax & Accounting business of Thomson Reuters. “And while getting at that money to solve a pressing financial crisis may be an unfortunate necessity, it isn’t easy,” he adds.

Hardship distributions involve three issues: (1) whether a distribution can be made under the rules; (2) how much can be distributed; and (3) the tax results of the distribution.

(1) Whether a distribution can be made. In general, O’Donnell says, there are only two ways for active employees who are under age 59 1/2 to tap their account balances in 401(k) plans: take a loan from the plan; or take a hardship withdrawal, if they are eligible to do so.

A distribution is treated as made after an employee’s hardship only if it is made “on account of” the hardship, which in turn requires that the distribution:

... be made on account of an immediate and heavy financial need of the employee; and
... be necessary to satisfy that financial need.

In general, the question of whether an employee has an immediate and heavy financial need is based on all relevant facts and circumstances. “A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee,” advises O’Donnell.

O’Donnell lists the following examples that might qualify for distribution as made on account of an immediate and heavy financial need:

- (1) Certain expenses for (or necessary to obtain) medical care (which includes expenses for the care of a spouse or dependent);
- (2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- (3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee’s spouse, children, or dependents;
- (4) Payments necessary to prevent the employee’s eviction from his principal residence, or foreclosure on the mortgage on that residence;



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(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents

A distribution *won't* be treated as necessary to satisfy an employee's immediate and heavy financial need to the extent it exceeds the amount required to relieve that need; or the need may be satisfied from other resources that are reasonably available to the employee. "For example, a vacation home owned by the employee's spouse generally will be deemed a resource of the employee," says O'Donnell. "However, a child's assets held in trust or under a uniform gifts to minors act aren't counted."

Additionally, the employee must establish that his immediate and heavy financial need can't reasonably be relieved by other means such as: through reimbursement or compensation by insurance or otherwise; by liquidating assets; by stopping elective contributions or employee plan contributions; or by other distributions or nontaxable loans from employer plans or by any other employer, or by borrowing from commercial sources on reasonable commercial terms. "Obtaining a hardship distribution is difficult for a reason," says O'Donnell. "It really should be a last-ditch solution to a very genuine need."

(2) How much can be distributed. A hardship distribution can't exceed the maximum distributable amount (MDA). "How the MDA is calculated can be complicated and can vary for each individual company," cautions O'Donnell. The MDA includes the employee's total elective contributions on the distribution date, reduced by any previous distributions of elective contributions. It also may include employer contributions depending on how those contributions are made (i.e., matching or nonelective), and how the plan is organized.

For example, a plan may provide that the MDA consists of elective contributions and the vested portion of employer matching contributions.

The portion of a withdrawal attributable to after-tax contributions would be determined on a pro-rata basis. The after tax portion of the distribution is equal to: (the employee's after-tax contributions ÷ total account balance) × the amount distributed.

O'Donnell provides the following example:

Jeff Smith has a plan account balance of \$100,000. Of that amount, \$10,000 represents his after-tax contributions. If Smith withdraws \$50,000 from his account on account of an immediate and heavy cash need, \$5,000 will represent a tax-free recovery of his after-tax contributions ($\$10,000 \div \$100,000 \times \$50,000$).

"Also, special hardship distribution rules apply if the employee contributed to a designated Roth account in a 401(k) plan," says O'Donnell.

(3) Income tax consequences. There's no special tax break for hardship distributions where the employee hasn't made any after-tax contributions. They are includible in gross income, and may be subject to an additional 10% premature withdrawal penalty tax to boot.

"The hardship distribution most likely will be hit with the 10% penalty tax," observes O'Donnell. "Withdrawing funds from an IRA may be a better choice if it would avoid the 10% penalty, e.g., because of the exception for education-related withdrawals."

"Also, distributions from cash or deferred arrangements made on account of hardship of the employee are not eligible rollover distributions and may not be rolled over to any IRA. Thus, for example, a participant making a hardship distribution from a 401(k) plan



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to use for education or a first-time home purchase can't roll over the amount to an IRA in order to avoid the 10% penalty.”

“Getting a hardship distribution from a 401(k) plan isn't easy, and shouldn't be used as a way to raise needed cash if other sources are available,” advises O'Donnell. “There are many qualifying conditions and some major financial consequences. An employee will have to pay tax at ordinary income rates on the withdrawal (assuming he's made no after-tax contributions) and, probably, a 10% premature withdrawal tax as well. The employee will forever lose the tax-deferred earnings buildup that would have accrued on the hardship withdrawal had it not been made.”

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