Caution: Read This Before You Tap Into Your 401(k)

By Scott Ho

Borrowing from your 401(k) may seem like a good idea when an emergency or unexpected expense arises, however, tapping into your retirement savings may be more trouble than it's worth.

Normally we'd all prefer to have enough room in our monthly budgets and daily savings accounts for competing needs or emergency expenses but sometimes we are forced to seek cash elsewhere. Perhaps your spouse lost their job and you just want to absorb the financial shock for a while. Whatever your reasons, withdrawing or taking a loan against your 401k funds is an option – after all, you're years from retiring and interest rates are often better compared to credit card and equity loans.

Unfortunately, touching your 401(k) retirement savings can come with some pretty hefty consequences. Before you borrow or withdraw funds from your 401(k), speak with your trusted financial advisor or benefits manager to fully understand the advantages and drawbacks in your given situation, find money from other sources or carefully devise a plan for borrowing and paying back your 401(k).

In the meantime, here are 5 reasons that should make you rethink using your 401k retirement savings for emergencies or ANY frivolous spending:

5 Reasons Not to Mess with Your 401k

#1 – You Must Pay Income Tax on a Withdrawal

If you find yourself on the verge of financial ruin you may not be able to avoid withdrawing funds from your 401(k), however tapping into that pension is going to cost you. Any amount withdrawn from your 401(k) is added to your ordinary income and will be taxed accordingly. For example, if you withdraw $10,000 and fall in the 25 percent income tax bracket, you will incur a tax liability of $2,500.

You will owe taxes on your money eventually, however most expect to wait to withdraw the money until retirement when it is more likely you have fallen in a lower bracket and owe less in taxes.

#2 – You Will Pay an Additional 10% Penalty for Withdrawals from a 401k Before 59 1/2

Not only will you have to pay income tax on the distribution, but you may incur an additional 10% tax penalty if you are under the age of 59 1/2. And that $10,000 withdrawal could cost you an additional $1000, leaving you with $6,500. If you absolutely need to $10,000 for spending, you will need to withdraw approximately $13,000 to cover the extra taxes and penalties.

There are certain circumstances which may exempt you from paying the penalty fee. These *Hardship Withdrawals* may allow you to escape some penalties, but do not be tricked into thinking they are loans; once you take the money out of your 401(k), you cannot put it back in and you lose the tax advantages on those funds.

Exceptions to the 10% Penalty

- Age 55 or older who has separated from their employer may be eligible for penalty free withdrawals
- You become permanently disabled
- You paid for medical expenses exceeding 7.5% of your adjusted gross income
- Qualified court mandated distributions for spousal, child or dependent support
- Purchasing a primary home (Although you may want to consider tapping into an IRA for $10,000 first to avoid the 10% penalty)
- College tuition, room and board, etc.)
- Preventing eviction or foreclosure on your home
- Certain home repairs
- Paying funeral costs for the burial of immediate family members
- If you died and your beneficiary receives the distribution

Before making a withdrawal, if you decide to make a withdrawal from your 401(k) account, you'll want to check with your employer for more information about your plan to see if you eligible for a hardship withdrawal. Then you need to take into consideration any additional income tax and penalty fees that will be applied to the amount you withdraw.

#3 – You May be Obligated to Repay a 401(k) Loan Immediately upon Termination

Some 401(k) employer plan allows include a loan feature allowing participants to borrow against the value of their 401(k) and pay themselves back with interest (typically through payroll deductions). Tapping into your retirement savings through a loan can be easier than going to the bank, however it will come with its own set of costs.

If you decide to take a loan against your 401(k) and then are terminated by your employer, you are obligated to pay back the entire outstanding balance of your 401(k) loan (usually within 1 to 3 months of your termination date). Whatever amount you do not repay is considered a 401(k) distribution and may be immediately subject to relevant income taxes and early withdrawal penalties.

#4 – Sets a Precedent for Frequently Borrowing from Your 401(k)

Since borrowing from a 401(k) is often cheap and easy, many people make the mistake of dipping into their retirement multiple times. One loan may not make a significant dent in your savings, but a second or third will. When it becomes a bad habit this sort of repeat borrowing can put a serious dent in your accounts and before you know it you have reduced your total retirement savings by 10, 20 or even 30%.

#5 – Can Permanently Jeopardize Your Long-Term Savings

Don't forget about the effect these 401(k) withdrawals and loan have on your ability to achieve long-term financial security. You lose the time and any potential compound earnings necessary to cover your expenses after retirement. **Here are 3 ways you could be limiting your total retirement savings by tapping into your 401(k) early:**

1. While repaying a 401(k) loan, you cannot make your normal pretax retirement account contributions. Note: Without pretax contributions, your reported income may rise, pushing you into the next tax bracket.
2. Money withdrawn (or loaned) is no longer invested, earning more money.
3. While paying back a 401(k) loan, borrowers tend to reduce their savings rate until the loan is paid off.

Consider the Alternatives to a 401(k) Loan or Withdrawal

The primary purpose of your 401(k) is to save for retirement; it is not intended to be a source of investment income or cash – until you're actually retired. Given the chances of incurring penalties, taxes, and decreasing your savings, does it ever make sense to tap into your 401(k)? Maybe, but to do so need an experienced financial advisor to help you minimize the costs.

Instead, consider these alternatives to dipping into a 401(k) retirement savings account:

- **An annuity or permanent life insurance policy** may have a similar tax deferred status, savings potential and loan features without affecting your long-term retirement savings potential.
- **A home equity loan** as the interest paid on the loan may be tax-deductible.
- **An IRA 72(t) withdrawal** also allow you to avoid the 10 percent early withdrawal penalty although it is taxable as income, similar to a hardship distribution from a 401(k).

Using your retirement account to pay for anything other than retirement is an expensive long-term move. It’s best to have an adequate emergency fund in reserve to avoid such moments of desperation in the first place. If you are faced with using your retirement savings, speak with a trusted financial advisor to examine the costs and available alternatives which will ensure you have a strong financial safety net for the future.