

BUSINESS

Missteps with 401(k) can be very costly

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401(k) ADVISER

MICHAEL FRANCIS



The "Great Recession" has forced some to accept a pay cut or unpaid time off. Worse yet, others have lost their job altogether. The financial hardship that ensues causes some to

consider draining their 401(k) as an easy source of cash.

My advice: Think twice.

Although your 401(k) may seem like an easy source for cash, tapping it early is almost always a bad idea because taxes and penalties make doing so expensive. It's common to see as much as 40% of your account disappear because distributions are generally taxed as ordinary income. If you're under the age of 59½, you're also hit with an additional 10% federal premature withdrawal tax.

Your retirement account should serve as the last line of defense when working through financial difficulties. But if you must access your retirement funds early, here's what you should know.

If you're still employed and desperately need cash, the IRS allows companies to grant hardship withdrawals from 401(k) plans to cover a limited number of circumstances, such as medical expenses, college costs, funeral expenses, casualty losses, and to prevent eviction from or foreclosure on your home.

Be prepared to provide evidence of the precise amount needed to satisfy your hardship and that you've exhausted all other potential sources of cash.

If you're considering a withdrawal from your plan, check with your plan administrator first. While it's allowed by the IRS, employers are not required to make hardship distributions available. Understand that taxes and penalties will still apply, even in a hardship situation.

Before you sign on the dotted line to request a hardship withdrawal, do the math. Let's say Karen, age 40, has a balance of \$20,000 and is in the 25% tax bracket. She'd net about \$11,800 after Uncle Sam and the Badger State are done with her.

When faced with today's problems, this may seem like a price she'd be willing to pay. But, that's not the total cost.

The total cost is the smaller account balance at retirement because she raided the account early. Instead, if she left the dollars to grow, she'd have about \$85,000 waiting for her, assuming a 6% annual return. Giving up this future balance is the real cost of an early cash-out.

A better alternative is to borrow from your account.

Some, but not all, employers allow for loans. A 401(k) loan is less costly than a hardship withdrawal because you won't owe any taxes or penalties as long as you repay the loan. Loans can't be for more than 50% of your account, or total more than \$50,000, and generally must be paid back within five years. The interest you pay on the loan goes back into your own account.

Although a loan is not as expensive as a withdrawal, there are costs. Consider the following:

•**Your account may not grow as quickly.**

It's true that you pay back the amount borrowed with interest. The interest you earn while repaying the loan may be significantly less than the returns if you remained invested in a diversified mix of funds over a full market cycle.

•**The entire repayment amount is double-taxed.** Loan payments are made in after-tax dollars. Let's say your monthly interest payment is \$300 and you're in the 28% tax bracket. You'll have to make \$416 in gross earnings to make the \$300 payment. Then, when you retire and take withdrawals, you pay

taxes yet again on the amount withdrawn. So each dollar is taxed twice.

•**If you terminate employment with a loan outstanding, the unpaid balance will likely be considered a premature distribution.** You'll owe federal and state income taxes as well as a 10% federal penalty and the applicable state penalty if you are under the age of 59½.

IRAs and previous employer plans are easier to get at. You're eligible for a withdrawal at any time for any reason, but income taxes and penalties still apply. Loans, however, are not available.

Understand, if you withdraw savings from a workplace retirement plan, the money comes out of the funds in the same ratio as your current balance. So if 80% of your savings is in stock funds, 80% of the distribution will come out of those funds, potentially forcing you to sell shares that have declined in value. With an IRA, you can specify which portion of your account to liquidate.

One strategy is to roll your savings into an IRA and invest it similarly. Then, take the withdrawal from the fixed-income portion, but only as you absolutely need the funds. This way your stock market holdings can be given time to recover.

Before tapping into your retirement accounts early, it's always a good idea to seek advice from an experienced adviser. They can assess your situation and provide guidance on the best way to lessen the pain of an early withdrawal.

Michael J. Francis, CIMA, JD is CEO of Francis Investment Counsel LLC, a registered investment adviser based in Pewaukee, WI. Mike Francis can be reached at michael.francis@francisinvco.com. The information contained herein is provided for informational purposes only. The preceding information has been obtained from sources Francis Investment Counsel believes to be reliable, but Francis Investment Counsel cannot guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes investment advice or a solicitation for the purchase or sale of any security. Past performance does not guarantee future results. Francis Investment Counsel does not offer personal tax or legal advice.