

WHY YOU SHOULDN'T WITHDRAW FROM YOUR 401(k) *Resist the temptation. Fight the urge. Fight for your future.*

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Recently, you may have heard about a spike in 401(k) withdrawals. The evidence is not merely anecdotal. Fidelity Investments recently issued its 2010 overview of the 401(k) accounts it administers and found that 22% of participants had outstanding loans from these retirement savings plans, with the average loan at \$8,650. In 2Q 2010, a record 62,000 of Fidelity's 401(k) participants had taken hardship withdrawals - a jump from 45,000 in the preceding quarter.^{1,2}

If at all possible, you should avoid joining their ranks.

The persuasive argument against a 401(k) loan. If you borrow from your 401(k), you are opening the door to some big risks (perhaps not immediately evident to you) and you may pay some severe opportunity costs.

- **What if you lose your job?** That's an all-too-common occurrence right now. If you get laid off or leave your job and you have an outstanding 401(k) loan, guess what - you usually have just 60 days to pay it all back, 60 days without income from work. Well, what if you don't pay it all back? The outstanding loan balance may be recharacterized as a 401(k) withdrawal. If you are younger than 59½, you may be assessed a 10% federal tax penalty on the "withdrawal amount", which by the way would be taxed as ordinary income.^{1,2}
- **What will you do with the money?** Will it be invested in anything? If not, it won't grow. When you take a 401(k) loan and use the money for an expense, you are forfeiting its potential for growth and compounding. (Think: how much could that lump sum grow over 20 or 30 years if your account returns 5% or 8% a year? Do the math, look at the potential.)
- **The terms of a 401(k) loan are less than ideal.** You can't deduct interest on a 401(k) loan, and that interest is typically one or two points above the prime rate. Here's another thing few people realize about 401(k) loans: when you pay the money back, you pay it back with after-tax dollars. Ultimately, those dollars will be taxed again when you take a 401(k) distribution someday.^{1,3}

The compelling case against hardship withdrawals. Sometimes these are made in worst-case scenarios - someone is being evicted or foreclosed on, or needs money to pay medical bills. Sometimes people think hardship withdrawals are "good debt" - they make these withdrawals in order to pay college costs or buy a house. Well, here are the reasons that you might want to look elsewhere for the money.

- **You may not be able to get a hardship withdrawal.** Some 401(k) plans don't allow them. Many do, but you will have to satisfy some IRS rules. Hardship withdrawals can only be made to pay medical expenses that are more than 7.5% of your adjusted gross income, to pay qualified tuition expenses, to pay funeral/burial costs, to buy a home, to make home repairs, or to stop eviction or foreclosure on a primary residence. Beyond those IRS requirements, the company you work for might have its own stipulations. Some firms won't give an employee a hardship withdrawal unless the employee can demonstrate that no other source can provide the needed funds.²
- **You may not be able to withdraw as much as you want.** Okay, let's say you are able to take a hardship withdrawal. The money is considered a retirement plan distribution. By law, your employer has to withhold 20% of it because you aren't making a trustee-to-trustee transfer with the funds. Are you younger than 59½? If so, you may be hit with an additional 10% tax penalty for early withdrawal. Regardless of your age, the amount you withdraw will be taxed as ordinary income. So besides the potential subtractions above, you'll lose even more of the lump sum you pull out to income taxes. Only in very rare cases can you get a hardship withdrawal without penalty (court order, total disability). Even in those circumstances, the money is still taxable.^{2,4,5}
- **You can't pay the money back.** It would be nice if you could, but you can't. To add insult to injury, after you reduce your retirement savings through the hardship withdrawal, you typically can't contribute to your 401(k) for the next six months.^{2,5}

Knowing all this, would you still consider these moves? Is it worth it to possibly do harm to your retirement savings potential? There are alternatives. Talk to a financial services professional - you may be pleasantly surprised to learn what other options might be available.

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Citations.

¹ kiplinger.com/columns/kiptips/archives/what-you-need-to-know-about-401k-loans.html [8/20/10]

² moneywatch.bnet.com/retirement-planning/blog/what-works/more-folks-raiding-401k-accounts/466/ [8/30/10]

³ bankrate.com/finance/debt/avoid-401-k-loan-to-pay-credit-card-debt.aspx [4/8/10]

⁴ fool.com/personal-finance/taxes/2005/05/23/job-changes-and-your-401k.aspx [5/23/05]

⁵ startribune.com/lifestyle/yourmoney/100647994.html [8/14/10]