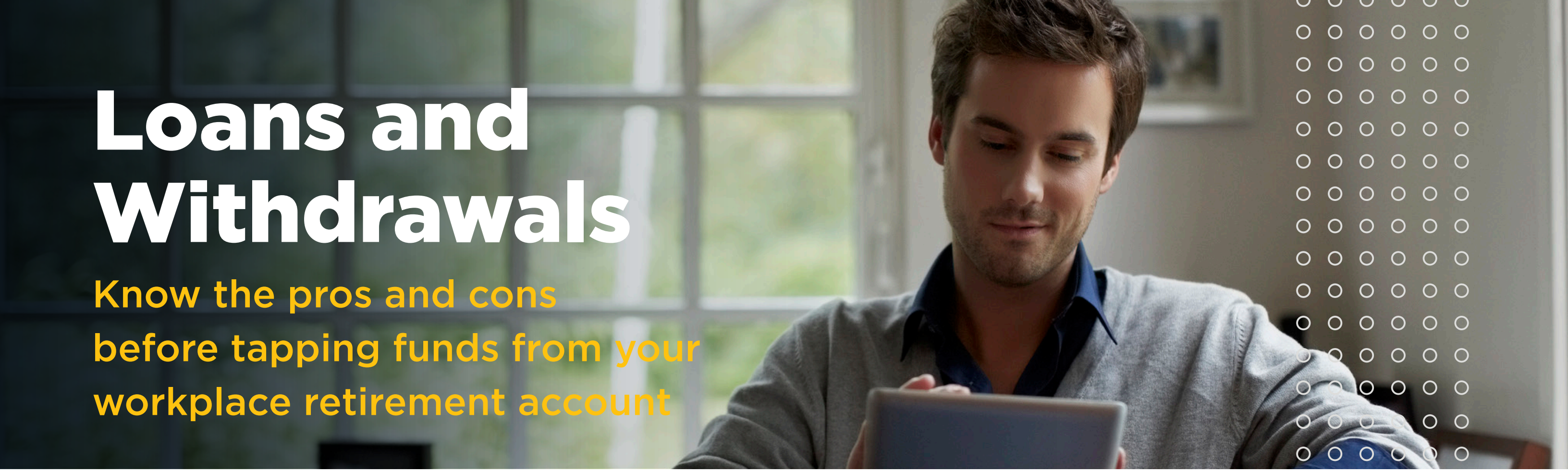

Loans and Withdrawals

Know the pros and cons before tapping funds from your workplace retirement account

During difficult economic times, you may be tempted to tap into your financial future — by taking a loan or a hardship withdrawal from your workplace retirement plan. But is it really a good idea? Individual circumstances vary, so there is no simple answer to this question. Let's take a closer look.

Plan Loans[1]

Typical retirement plans allow you to borrow up to half your vested balance, up to $50,000. Your employer may restrict the reasons you can take a loan, such as to pay for medical or education expenses, prevent eviction or buy a first home. Some may allow you to take a loan for any reason. The loan generally must be paid back with interest over five years. Loan payments are automatically deducted from your paycheck.

The Pros

- What makes loans attractive is that while you do pay interest on them, the rate is relatively low, and you actually pay the interest to yourself.
- Having loan payments automatically deducted from your paycheck makes repayment simple.
- Getting a loan from your retirement plan is usually quick and convenient. There are no credit checks or applications — often a simple form, call or a few clicks online will complete the process.

The Cons

- When you remove retirement savings from your account, you're lessening its ability to earn compound interest. It's exactly this compounding effect that makes tax-deferred saving so attractive. Reducing compounding potential can have a significant effect on your savings in the long run.
- Loan fees are taken directly from your account, further reducing its potential growth.
- The money you use to repay the loan is taxed twice. Loan repayments are paid back to the plan after tax and join the pre-tax money already in the plan. The money you used to repay the loan will be taxed again upon withdrawal from a traditional retirement plan account.
- If you fail to pay off the loan, you will owe income taxes as if you had taken a distribution from your plan account. In addition, if you lose your job after you take out that loan, you have to pay back the whole amount — usually within 60 days. If you don't, then you get hit with a huge tax bill and an early withdrawal penalty.

Hardship Withdrawals[1]

Two types of hardship withdrawals are allowed from workplace retirement plans. One is called a financial hardship withdrawal. It is subject to any applicable income taxes (federal, state and local), as well as an additional 10% penalty if you are younger than 59½. Financial hardship withdrawals are allowed for the following reasons:

- To buy a primary residence
- To prevent foreclosure or eviction from your home
- To pay college tuition for yourself or a dependent, provided the tuition is due within the next 12 months

- To pay unreimbursed medical expenses for you or your dependents
- Funeral expenses
- Certain expenses for the repair of damages to your principal residence

The other type of hardship withdrawal is a penalty-free withdrawal, made under Section 72(t) of the Internal Revenue Code. With this type of withdrawal, you must pay income taxes. However, the 10% early withdrawal penalty is not applied. You may qualify to take a penalty-free withdrawal if you meet one of these exceptions:

- You become totally disabled
- You are in debt for medical expenses that exceed 10% of your adjusted gross income (AGI)
- You are required by court order to give the money to your divorced spouse, a child or a dependent
- You are separated from service (through permanent layoff, termination, quitting or taking early retirement) in the year you turn 55 or later
- You are separated from service and you have set up a payment schedule to withdraw money in substantially equal amounts over the course of your life expectancy. Once you begin taking this kind of distribution you are required to continue for five years or until you reach age 59½ (whichever is longer)

The Pros

The biggest advantage of withdrawing from your retirement account is simply the security of knowing you have access to your money if you need it. If you take money out of your 401(k), you can pay your bills, buy a house or even take a vacation.

The Cons

- If you are under age 59½, you may lose 30–40 percent of the withdrawal in taxes and penalties. For example: suppose you fall in the 22 percent tax bracket. If you take a $10,000 hardship withdrawal to pay for your child's college tuition, you will owe $2,200 in federal income taxes and an additional $1,000 to cover the early withdrawal penalty. You'll be left with $6,800, or even less if you also owe state and local income tax.
- Taking a hardship withdrawal can also result in longer-term costs — a less generous retirement. Take the example of a person who, starting at age 30, contributes $5,000 a year to her workplace retirement plan. At age 40, she buys a house and takes a $10,000 hardship withdrawal for the down payment. Let's assume her portfolio generates an average annual return of 8 percent. By retirement at age 65, she will have $793,094. **Had she not taken the hardship withdrawal she would have had $861,584, or $68,490 more[2]**.

[1] The 2020 CARES Act lets you make a penalty-free COVID-19 related withdrawal or take out a loan from your workplace retirement plan in 2020 with special repayment provisions and tax treatment.

- For calendar year 2020, COVID-19 related hardship withdrawals can be up to 100% of your account balance or $100,000, whichever is smaller.
- If the loan is COVID-19 related and taken out between Mar. 27 and Sep. 23, 2020, you can borrow up to 100% or $100,000, whichever is less.

[2] This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

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