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February 19, 2008

### **Consumers risk taxes, penalties when they raid their 401(k) retirement accounts**

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Index Terms:

Financial

Article Text:

Although 401(k) and other employer-sponsored retirement accounts are supposed to be for long-term saving, many of the plans allow participants to take money out early under special circumstances. But under tax laws, there can be serious investment and tax consequences if people borrow or withdraw from their accounts before age 59 1/2:

Q. Do a lot of people tap their 401(k)s?

A. In recent years, about 18 percent of plan participants have taken loans against their accounts, according to studies by the Investment Company Institute and Employee Benefit Research Institute. The average unpaid balance at the end of 2006 was just under \$7,300, the Washington, D.C.-based groups said.

Q. Is it such a bad idea?

A. "This should be the very last resort," said David Wray, president of the ProfitSharing/401(k) Council of America in Chicago. "This is your long-term savings, and you interrupt both your savings and your earnings when you make withdrawals."

Q. What are the penalties if I cash out the whole account?

A. The worst thing a consumer can do is cash out a 401(k). Because these accounts are funded with pretax money, they become taxable when money is withdrawn. And if the worker is younger than 59 1/2, the amount of the withdrawal also can be subject to a 10 percent penalty. So if a worker is in a 25 percent federal tax bracket and is younger than 59 1/2, he or she could lose 35 percent of the money to taxes and penalties.

Q. So a loan is better?

A. Definitely. The way it works is that a consumer can borrow \$50,000 or half of the vested balance in the account, whichever is lower, according to the ICI. The worker must pay the loan back, usually within five years, with interest generally set close to what a bank would charge, it said.

Loans are generally paid with deductions from a worker's paycheck. The worker can continue to contribute to the plan, though many find it necessary to cut back until the loan is repaid. If they cut back too much, they may miss out on some of an employer's

"matching" money. The worker also misses out on the earnings on the money that's withdrawn.

Further downside: If an employee defaults on the loan or leaves a job without paying it all back, the outstanding balance is taxable and the 10 percent penalty can apply, tax lawyers say.

Q. But what if it's an emergency?

A. Generally if someone wants a hardship distribution, an employer first will ask the worker to take a loan for half of the account balance, Wray said. "The company is saying, 'We'll give you the whole thing ... but we'd like to protect you a bit if we can,'" he said. Most companies limit emergency withdrawals to those categories approved by the Internal Revenue Service: medical expenses, purchase of a principal residence, to prevent foreclosure or eviction, repair of storm damage, payment of tuition, payment of funeral expenses.

Employees will have to pay income taxes on the withdrawal and, in many cases, the 10 percent penalty also will apply.

Further downside: Most plans bar employees from making 401(k) contributions for at least six months after a hardship distribution.

Q. If I'm young and I take a hit because of a loan or emergency withdrawal, I can make it all up in the long run, can't I?

A. Sarah Holden, senior director for retirement and investor research at the ICI, said studies have found that "people who take early withdrawals tend to have smaller nest eggs at retirement."

This is especially true for lower-income families, she said. A study done by EBRI and the ICI found that lower-income workers who never took a preretirement withdrawal from the 401(k) would have 13 percent more in retirement than those who did tap their savings, she said.

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Record Number: D8UTJC500