Plan loans and withdrawals

What to consider carefully

Do you need money to help cover an unexpected expense? If so, you may be able to access some of your money from your employer-sponsored 401(k) plan before you actually retire — either through a loan (if your plan offers loans) or a withdrawal (if you're eligible for one).

But keep in mind the larger expense you'll eventually have to pay for — your retirement. So ask yourself some key questions before taking a loan or withdrawal:

- How urgently do you need the money?
- Can you get the money from another source?
- Do you really want to use assets you've earmarked for your retirement?
- How will your money be taxed?

Is borrowing from your plan a good idea?

If your plan allows loans, taking a loan against your vested account balance may seem attractive. After all, you may not need the money in your account for years, the interest rate may be competitive, and a loan, typically, is easy to arrange.

But while there are potential advantages in taking a loan, there are also potential disadvantages to consider.

Potential advantages of taking a loan	**Potential disadvantages of taking a loan**
• You pay a reasonable interest rate, often just a point or two above the prime rate	• The money you take out loses the potential for tax-deferred compounding
• There is no credit check	• You repay the principal and interest with after-tax dollars (even though your contributions may have been on a pre-tax basis)
• You pay the interest to yourself, not to a bank or credit card company	• Loan repayments reduce your current take-home pay
• Typically, there are no restrictions on how you can use the money for a general purpose loan	• You may incur loan initiation and/or maintenance fees
• The loan application process can be quicker than with bank loans	

The opportunity you'll miss

If you take out a loan, that money isn't invested in your account until you pay it back. So you'll be missing an opportunity for potential growth.

The more money you leave in your account, the better your chances could be for a higher account balance when you retire.

How to get started with a loan

Contact your Plan's service provider to start the loan application process.

You'll need to decide:

- The type of loan you want
- The amount of the loan
- The payment frequency
- The number of repayments
- The delivery method (check or direct deposit)

Your service provider should provide information about the interest rate to be charged on the loan and your expected payments.

Consider all of your options

Even considering the drawbacks, there are instances where taking a loan against your 401(k) balance could be beneficial.

If you're considering purchasing a home, in some cases a higher down payment could potentially lower the interest rate on your mortgage. And you could borrow against your 401(k) account to pay off your credit card balance, which may carry a much higher interest rate than your loan.

But be sure to consider alternative money sources before borrowing from your 401(k) account. You don't want to take money out of your account today, only to realize you don't have what you need tomorrow. And if you do take a loan from your account, repay it as quickly as you can and try not to cut back on your plan contributions. It could make a difference to your financial future.

What about taxes?

When you take a loan, you are not taxed on the amount of the loan.

However, if you leave your employer with an outstanding loan, most plans require you to repay your loan within 30 to 60 days. If you don't, the outstanding loan balance may be offset against your plan account and considered a taxable distribution (and you may also be subject to a 10% additional federal tax if you are under age 59½ and no exception applies).

You can, however, generally avoid current taxation by making a rollover to an eligible retirement plan equal to the amount of the loan offset by your tax filing due date, including extensions, for the year in which the loan offset occurs.

What about a withdrawal?

If you meet certain criteria established by your employer's plan, you may be able to take a withdrawal for certain expenses.

But, like a loan, the money you withdraw would lose the potential for tax-deferred investment growth. And, unlike a loan, a withdrawal from your account would be a taxable event. This means your withdrawal would be subject to federal income tax as ordinary income. In addition, unless you qualify for an exception, you will also be subject to a 10% additional federal tax on withdrawals taken before age 59½.

Please review your Summary Plan Description or IRS Publication 575 to see what may qualify as an exception to the early withdrawal tax.

What is a hardship withdrawal?

If you are under 59½, you generally cannot take a withdrawal of your own pre-tax or Roth contributions while you are working — except in the case of a hardship withdrawal.

Tax laws govern what qualifies as a hardship withdrawal. The "immediate and heavy financial need" that would qualify as a reason for a hardship withdrawal would generally include, among other things:

- Unreimbursed medical expenses for you, your spouse, or dependents
- Purchase of your principal residence
- Funeral expenses

If your employer's plan allows for hardship withdrawals, the list of what qualifies as a reason for a hardship withdrawal is included in the plan's Summary Plan Description (or other materials).

A hardship withdrawal would generally be subject to federal income tax, and it can't exceed the amount of the need. But the amount required to satisfy the financial need may include amounts needed to cover taxes due on the withdrawal.

How withdrawals are taxed

Federal income taxes on pre-tax contributions, any company contributions, and earnings on those contributions are due upon withdrawal. You will not be taxed on a withdrawal of traditional after-tax contributions, but earnings on those contributions would be taxed.

Roth 401(k) contributions are not taxed upon withdrawal. Earnings on Roth 401(k) contributions are not subject to federal income tax upon withdrawal provided you take a "qualified distribution."[1]

And any taxable withdrawals are also subject to the 10% additional federal tax if taken before age 59½, unless an exception applies.

[1] A qualified withdrawal or distribution is one that is taken at least five tax years after the first day of the year of your first Roth 401(k) contribution to the plan, or conversion if earlier, and after you have attained age 59½ (or upon disability or death). If you take a non-qualified withdrawal of your Roth 401(k) contributions, any Roth 401(k) earnings are subject to federal ordinary income taxes, plus a possible 10% additional federal tax if withdrawn before age 59½, unless an exception applies. State income tax laws vary; consult a tax professional to determine how your state treats Roth 401(k) distributions.

Questions?

Contact your Plan's service provider.

How to get started with a withdrawal

Contact your Plan's service provider to initiate a withdrawal.

You'll need to choose the type of withdrawal (for example, hardship) and the withdrawal amount. Your provider should then provide the amount you'll receive after taxes and any fees are deducted.

You'll then choose:

- The sources you want to withdraw from (for example, your pre-tax contributions or any employer match)
- The investments to sell to fund the withdrawal
- How you want to receive the money (check or direct deposit)

Considering a distribution?

If you no longer work for the company that sponsors the plan, you could take a distribution from your account. How you choose to take a distribution should reflect your financial circumstances, needs and goals.

If you take a cash distribution, any pre-tax assets distributed will be included as part of your gross income subject to federal income tax, and you might also be subject to the 10% additional federal tax on early withdrawals if you are under age 59½ and no exception applies.

But you could preserve the tax-favored status of your assets by rolling them over to an IRA or a Roth IRA. Moving them to a new employer's plan would also preserve their tax-favored status. Or you could leave the account where it is, subject to the rules of the plan.

Each choice may offer different investments and services, fees and expenses, withdrawal options, required minimum distributions, and tax treatment (particularly with reference to employer stock), and provide different protection from creditors and legal judgments. These are complex choices and should be considered with care.

To learn more about the potential advantages and disadvantages of each choice, you can review the Distribution Options Flyer.

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