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Hardship Withdrawals and Loans: Some Words of Caution

Emily G. Brown JD
University of Massachusetts Boston

Jeanne Medeiros JD
University of Massachusetts Boston

Ellen Bruce JD
University of Massachusetts Boston

Fact Sheet
PENSION ACTION CENTER, GERONTOLOGY INSTITUTE
JOHN W. McCORMACK GRADUATE SCHOOL OF POLICY AND GLOBAL STUDIES

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As defined benefit pension plans become more and more rare, the responsibility of saving for retirement falls increasingly on individuals. Many studies have been published about the average or median balances in retirement savings accounts and virtually all of them have reached the same conclusion—most Americans aren't saving enough money to last them through their retirement years.

In this fact sheet we look at one of the factors that contributes to this problem, that is, the availability of loans and hardship withdrawals from 401(k) retirement accounts, which can lead to lower account balances overall. Sometimes, when you are facing a financial need, you might look to borrow or withdraw money from your retirement account. This approach may be an option, but there are a number of things you should consider first. This fact sheet highlights some of the reasons why taking these loans and withdrawals might have a long-term impact on a person's retirement security.

Hardship Withdrawals

A hardship withdrawal enables a plan participant to withdraw funds in times of immediate and heavy financial need. A 401(k) plan is not required to permit hardship withdrawals, but may permit them if they adhere to the Internal Revenue Service guidelines.

These rules require that **the hardship withdrawal should be a last resort for participants**. Before getting a hardship withdrawal, you must:

1. first, exhaust all distributions or nontaxable loans available under the plan,
2. demonstrate that you have no other funds available to meet the need,
3. show that the amount being withdrawn is necessary to satisfy the need, but is not in excess of the needed amount, and
4. show that the withdrawal is necessary due to an "immediate and heavy financial need." [1]

[1] http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Hardship-Distributions
IRS rules & Regs (Reg. §1.401(k)-1(d)(3)(iv)(B))

Acceptable reasons for a hardship withdrawal may be:

1. To pay for medical expenses for you, your spouse, or dependent
2. To pay for funeral expenses
3. To make payments necessary to prevent eviction from your home or foreclosure on your principal residence
4. To repair damage to your principal residence
5. To pay costs directly related to the purchase of your principal residence
6. To pay college tuition and costs for yourself, your spouse, your dependent, or your child who is no longer a dependent.

Remember, plans are not required to allow hardship withdrawals, so you should check the plan's Summary Plan Description to see if your plan does, and to see what the requirements are.

Consequences of Hardship Withdrawals are Both Short- and Long-Term

As you can see, it may be quite difficult to get a hardship withdrawal from your 401(k) plan. If you receive it, **it may be more costly than you think, since it is depriving you of money that you may need for your retirement years. The withdrawal will permanently reduce your retirement savings because it is not repayable**. For this reason, most financial advisors would tell you that it really should be a last resort.

Some of the immediate and short-term consequences are:

1. The withdrawal likely will be taxed as gross income.
2. In most cases, the withdrawal will face a 10% penalty tax for an early distribution, unless you are over 59 ½.[2]
3. There will likely be a 20% withholding for income taxes.
4. You will be prohibited from making employee contributions and employee elective contributions for six months after taking the withdrawal.

Loans

Sometimes people think that borrowing money from their 401(k) account is the same type of financial decision as going to the bank and taking some money from their savings account. But taking a loan from a 401(k) may have very different consequences, both long- and short-term, and you should only make this decision after you have considered all of these consequences.

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[2] Distributions before age 59 ½ are generally subject to a 10% penalty tax. Some exceptions apply to this rule. More information can be found on the IRS website: http://www.irs.gov/taxtopics/tc558.html

Short-Term Consequences of Loans from 401(k) Plans

1. Loans must be paid back, usually within one to five years; however, some exceptions apply.
2. The funds that come out of your paycheck to pay back the loan are post-tax money, not pre-tax. You also pay interest on the loan.
3. If you leave the employment before you have repaid the loan in full, you can request a coupon book to continue making payments on your own, or the employer can treat the remaining balance as a lump-sum distribution. If you default on the loan, it will also be treated as a lump-sum distribution.
4. The amount that is considered a lump sum distribution (see above) would then be subject to income taxes and the 10% early withdrawal penalty tax. So, for example, if you didn't pay back $10,000, you will pay a $1,000 penalty and also pay income taxes on $10,000. In other words, you could find yourself looking at a big, unplanned tax bill.
5. While the amounts you <u>contribute</u> to your 401(k) account as regular contributions are not treated as taxable income, the amounts you pay to repay the loan do come out of your taxable income. This means that you are taking pre-tax money out of your account and repaying it with after tax money—this may cost you much more than you think.

Long-Term Consequences of 401(k) Loans

When you pull money out of your retirement account, you are using money that would otherwise be working for you, building toward your retirement income security. One of the greatest features of these plans is that your money is earning compound interest; this means that the interest you earn one year gets added to the principal and also earns interest. Over time, this causes the money in your account to grow more rapidly. While you are slowly repaying the loan amount, you are slowing the growth of your 401(k) overall, and losing out on the opportunity to have your money working for you.

Conclusion

Emergencies do happen, and there are times when you might really need some extra money to meet these challenges. Ideally, you should try to have an emergency fund set aside for just that reason. If you don't and are considering using some of your retirement funds, most experts would recommend that you take a loan rather than a hardship withdrawal. Hopefully, you will be able to repay the loan and restore some of the value to your account. As mentioned earlier, the hardship withdrawal is *not* repayable to the plan, so your retirement account loses that money permanently. In general, you would not be able to get a hardship withdrawal if you are eligible for a loan, since you do have to exhaust all your available resources to qualify for a hardship withdrawal.

In today's world, we all need to maximize the amounts in our 401(k) and other retirement accounts. While you may look at the money in your 401(k) account and think that, since it is your money, you should be able to tap into it when you need it, we advise you strongly consider the hidden costs and downsides of taking either a loan or a hardship withdrawal.

Do you have any questions about this fact sheet? Call the Pension Action Center at 888-425-6067 or visit us online at pension.umb.edu

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This fact sheet is intended to provide general information about pensions and other retirement benefits and should not be used as a substitute for a consultation with an attorney or other legal professional. Individuals should always consult a legal or financial advisor to discuss the facts and circumstances of their specific situations.

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