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Borrowing or Withdrawing Money from Your 401(k) Plan

If you have a 401(k) plan at work and need some cash, you might be tempted to borrow or withdraw money from it. But keep in mind that the purpose of a 401(k) is to save for retirement. Take money out of it now, and you'll risk running out of money during retirement. You may also face stiff tax consequences and penalties for withdrawing money before age 59½. Still, if you're facing a financial emergency--for instance, your child's college tuition is almost due and your 401(k) is your only source of available funds--borrowing or withdrawing money from your 401(k) may be your only option.

Plan loans

To find out if you're allowed to borrow from your 401(k) plan and under what circumstances, check with your plan's administrator or read your summary plan description. Many employers allow 401(k) loans only in cases of financial hardship, but you may be able to borrow money to buy a car, to improve your home, or to use for other purposes.

Generally, obtaining a 401(k) loan is easy--there's little paperwork, and there's no credit check. The fees are limited too--you may be charged a small processing fee, but that's generally it.

How much can you borrow?

No matter how much you have in your 401(k) plan, you probably won't be able to borrow the entire sum. Generally, you can't borrow more than \$50,000 or one-half of your vested plan benefits, whichever is less. (An exception applies if your account value is less than \$20,000; in this case, you may be able to borrow up to \$10,000, even if this is your entire balance.)

What are the requirements for repaying the loan?

Typically, you have to repay money you've borrowed from your 401(k) within five years by making regular payments of principal and interest at least quarterly, often through payroll deduction. However, if you use the funds to purchase a primary residence, you may have a much longer period of time to repay the loan.

Make sure you follow to the letter the repayment requirements for your loan. If you don't repay the loan as required, the money you borrowed will be considered a taxable distribution. If you're under age 59½, you'll owe a 10 percent federal penalty tax, as well as regular income tax on the outstanding loan balance (other than the portion that represents any after-tax or Roth contributions you've made to the plan).

What are the advantages of borrowing money from your 401(k)?

- You won't pay taxes and penalties on the amount you borrow, as long as the loan is repaid on time

- Interest rates on 401(k) plan loans must be consistent with the rates charged by banks and other commercial institutions for similar loans
- The interest you pay on borrowed funds is generally credited to your own plan account; you pay interest to yourself, not to a bank or other lender

What are the disadvantages of borrowing money from your 401(k)?

- If you don't repay your plan loan when required, it will generally be treated as a taxable distribution.
- If you leave your employer's service (whether voluntarily or not) and still have an outstanding balance on a plan loan, you'll usually be required to repay the loan in full within 60 days. Otherwise, the outstanding balance will be treated as a taxable distribution, and you'll owe a 10 percent penalty tax in addition to regular income taxes if you're under age 59½.
- Loan interest is generally not tax deductible (unless the loan is secured by your principal residence).
- You'll lose out on any tax-deferred interest that may have accrued on the borrowed funds had they remained in your 401(k).
- Loan payments are made with after-tax dollars.

Hardship withdrawals

Your 401(k) plan may have a provision that allows you to withdraw money from the plan while you're still employed if you can demonstrate "heavy and immediate" financial need and you have no other resources you can use to meet that need (e.g., you can't borrow from a commercial lender or from a retirement account and you have no other available savings). It's up to your employer to determine which financial needs qualify. Many employers allow hardship withdrawals only for the following reasons:

- To pay the medical expenses of you, your spouse, your children, your other dependents, or your plan beneficiary
- To pay the burial or funeral expenses of your parent, your spouse, your children, your other dependents, or your plan beneficiary
- To pay a maximum of 12 months worth of tuition and related educational expenses for post-secondary education for you, your spouse, your children, your other dependents, or your plan beneficiary
- To pay costs related to the purchase of your principal residence
- To make payments to prevent eviction from or foreclosure on your principal residence
- To pay expenses for the repair of damage to your principal residence after certain casualty losses

Note: You may also be allowed to withdraw funds to pay income tax and/or penalties on the hardship withdrawal itself, if these are due.

Your employer will generally require that you submit your request for a hardship withdrawal in writing.

How much can you withdraw?

Generally, you can't withdraw more than the total amount you've contributed to the plan, minus the amount of any previous hardship withdrawals you've made. In some cases, though, you may be able to withdraw the earnings on contributions you've made. Check with your plan administrator for more information on the rules that apply to withdrawals from your 401(k) plan.

What are the advantages of withdrawing money from your 401(k) in cases of hardship?

The option to take a hardship withdrawal can come in very handy if you really need money and you have no other assets to draw on, and your plan does not allow loans (or if you can't afford to make loan payments).

What are the disadvantages of withdrawing money from your 401(k) in cases of hardship?

- Taking a hardship withdrawal will reduce the size of your retirement nest egg, and the funds you withdraw will no longer grow tax deferred.
- Hardship withdrawals are generally subject to federal (and possibly state) income tax. A 10 percent federal penalty tax may also apply if you're under age 59½. (If you make a hardship withdrawal of your Roth 401(k) contributions, only the portion of the withdrawal representing earnings will be subject to tax and penalties.)
- You may not be able to contribute to your 401(k) plan for six months following a hardship distribution.

What else do I need to know?

- If your employer makes contributions to your 401(k) plan (for example, matching contributions) you may be able to withdraw those dollars once you become vested (that is, once you own your employer's contributions). Check with your plan administrator for your plan's withdrawal rules.
- If you were impacted by Hurricanes Katrina, Rita, or Wilma, or if you are a reservist called to active duty after September 11, 2001 and before December 31, 2007, special rules may apply to you.

Timothy J. McNeely is a Financial Adviser, CERTIFIED FINANCIAL PLANNER™ and a Certified Investment Management AnalystsSM Practitioner with [The McNeely Group at Smith Barney](#). He provides comprehensive wealth management advice. His focus is on how to help you grow, preserve and distribute your assets in the face of tumultuous financial markets and life-changing events. He can help you seek a comfortable retirement, tackle long-term-care issues and reduce the impact of taxes and other factors that may erode your wealth over time. You can reach him at 818-382-5779.

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