Avoid Tapping Into 401(k) Early

If you've been contributing for many years to your 401(k) or similar retirement plan, it may be your largest pool of money. So, if you are facing a financial need, you may think about tapping into your account. After all, it's your money – why not use it?

But touching your 401(k) before you retire may not be a good idea, as it can lead to some unwanted consequences.

First, taking funds out of your 401(k) now could increase the risk of running out of money during retirement, which could last for decades.

Also, withdrawals taken from your 401(k) before age 59½ may be taxed as ordinary income and are generally subject to a 10% penalty for early withdrawal, although there are some exceptions. And a sizable taxable withdrawal from your 401(k) could bump you into a higher tax bracket.

Therefore, if you are facing a financial crunch, you may want to explore some options before tapping into your 401(k). For starters, see if you can cut your expenses where possible and explore financial assistance programs that service providers, such as utility companies, might offer.

Also, if you have an emergency fund, now may be the time to use it. For most folks, it's a good idea to keep three to six months' worth of living expenses in such a fund, with the money kept in a liquid, low-risk account. But even smaller amounts can help in a financial crunch.

You might also find another source of cash in your taxable investment accounts. Any uninvested cash in these accounts is an easy place to start. You might also look at selling investments to free up some cash. However, before making this decision, you may want to consult with a financial professional to discuss the pros and cons.

Another cash-generating option is a 401(k) loan, assuming your plan permits such loans. Unlike a direct withdrawal, a 401(k) loan is not taxable if it's repaid on time. (If it isn't, you could also incur penalties.) And, although the loan may have some fees, the interest on it will be paid to your account, rather than to a bank. However, you won't earn investment returns on the loan balance, because you can't use this money to invest. And if you leave your job before you've fully repaid the loan, you'll likely have to come up with the remaining balance quickly.

You could also consider using your credit cards to generate cash, but these types of loans or advances can be quite costly. Instead, you may want to look at other possibilities, such as a home equity loan, the cash value of a life insurance policy, the "margin" on your investment accounts or a personal loan. Again, you should talk to a financial professional to discuss the tradeoffs of taking out these loans and to develop a payoff strategy, if you decide to use any of them.

Your 401(k) is a long-term investment designed to meet a long-term goal: your retirement. So, if you think you might require these funds before retirement, explore all alternatives first to find the right decision for your needs.

This article was written by Edward Jones for use by your local Edward Jones Financial Advisor.