Should You Consider 401(K) Loans or Withdrawals?

At some point, you may have more money in your 401(k) than in any other investment. And even though your 401(k) is intended for your retirement, you may one day think you have to tap into your account early — but should you? And if you do, how should you go about it?

If it's possible to avoid taking money from your 401(k) before you retire, you probably should do so. You could spend 25 or more years in retirement, and you'll need to pay for those years, so you may want to look for alternatives to your 401(k). If you've built an emergency fund containing several months' worth of living expenses in cash or cash equivalents, you could use some of this money. If you have a Health Savings Account (HSA), you could use it to pay for qualified medical expenses. Or you could sell some of your taxable investments, rather than going into your tax-deferred 401(k).

But if you have determined that you must look at your 401(k) plan to meet a short-term funding need, you'll want to carefully consider how to go about it. You typically have two main choices: loans or withdrawals.

For plans that allow loans, employees can generally borrow up to 50% of the vested amount of their 401(k)s, up to a maximum of $50,000 within a 12-month period. Administrative fees may apply, and Interest will be charged, but it will be added back to the 401(k) account as part of the loan repayments. Except when they're used for a home purchase, loans must be repaid within five years, with equal payments made at least quarterly, unless payments are allowed to be paused temporarily. If you leave the company or don't repay the loan according to the agreement, the loan balance will likely be treated as a taxable distribution.

Now, let's consider withdrawals. For 401(k) plans that allow current employees to make withdrawals, the withdrawal requests are usually considered either hardship or non-hardship. To qualify for a hardship withdrawal, you must demonstrate an immediate and heavy financial need to pay for certain expenses, including a home purchase, college, a medical issue or other specified costs, and your withdrawal is limited to the amount necessary to meet the need. Non-hardship withdrawals can typically be taken for any purpose but usually are not granted until you're 59½ or older.

Unlike with a loan, a hardship withdrawal can't be repaid, while a non-hardship withdrawal can usually only be repaid by rolling over the amount to an IRA within 60 days. But the bigger issue may be taxes. If you withdraw funds from your 401(k), any previously untaxed money is generally taxed as ordinary income and a 10% penalty will apply if you're younger than 59½, unless you qualify for an exception. Plus, your 401(k) plan typically must withhold 20% of the withdrawal for taxes, so you'd have to take an even larger withdrawal to meet your needs.

Before embarking on a 401(k) loan or withdrawal, you may want to consult with a financial professional and your tax advisor. Taking money from your 401(k) is a big move, so make sure you know everything that's involved.

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

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