

Best Ways to Tap Retirement Cash

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In normal times, a prudent rule for managing your finances is: Don't ever take money out of your IRA or 401(k) money before age 59½. An early withdrawal from a retirement plan will generally sock you with taxes plus a 10 percent tax penalty. Worse, you'll lose out on potential growth in your nest egg, which could make it rougher to retire when you want.



But these aren't normal times.

Because the recession has thrown millions out of work and tightened the vise on others, financial planners are increasingly hearing from clients who want to tap their retirement plans for short-term needs. "Many people had most of their capital in retirement assets or home equity, and now there's just not as much home equity as there used to be," says Kevin Meehan, a certified financial planner with Summit Wealth Advisors, at Raymond James Financial Services, Inc. Member FINRA/SIPC in Itasca, Ill.

If you urgently need to lay your hands on some cash, those retirement accounts (albeit smaller than a few years ago) may look tempting. Even so, most advisors say you should only consider a "hardship withdrawal" after you've exhausted other possibilities (see the table below for alternate sources of funds to try first).

If you must, really *must*, withdraw or borrow from your IRA or 401(k), do it in this order, starting with the best choice:

401 (k) Loan

Borrowing 401(k) money can be far less costly than running up your credit cards — as long as you have the discipline and ability to replace the money in your company plan in a few months. "A lot of people are reluctant to borrow because they don't want to harm their futures. But instead, they end up borrowing at a much higher rate on their credit cards," says Moshe Milevsky, professor of finance at York University Canada and author of *Your Money Milestones*.

Ask your HR department whether your company lets you borrow against your plan. If so, you won't incur taxes or penalties, but you will pay interest: typically the prime rate plus one or two percentage points, which would be 4.25 to 5.25 percent today. The good news is, you're paying the interest to yourself. You'll need to pay off the loan within five years. By law, if the plan permits loans, you can borrow up to 50 percent of your vested balance, with a maximum loan of \$50,000.

Here's the giant caveat: If you borrow from your 401(k) and then quit or get fired, you'll usually be required to pay it back within 60 days or the loan will be considered an early withdrawal. On a \$10,000 loan, you'd owe \$1,000 in penalties, plus income tax.

Roth IRA Withdrawal

A Roth IRA withdrawal could be your next most economical option. The IRS lets you pull out Roth IRA contributions without incurring income tax, even if you make the withdrawal before age 59½. However, if you withdraw any *earnings* before 59½, you'll owe taxes at your ordinary income tax rate. Also, unless you'll return the money within 60 days (more on that later), you'll owe the 10 percent early withdrawal penalty.

The 10 percent penalty is waived, however, if you're disabled or if the money will be used for these purposes:

- Paying medical expenses greater than 7.5 percent of your income
- Paying health insurance premiums after you've been receiving unemployment insurance for more than 12 weeks
- Making a first-time home purchase (maximum penalty-free withdrawal: \$10,000)
- Paying tuition for yourself or dependents
- Paying the IRS back taxes

Traditional IRA Withdrawal

The same rules about penalties apply as for Roth IRAs. But here's the big difference between traditional IRA withdrawals and Roth IRA withdrawals: Unlike a Roth IRA, you'll owe income tax on *any* traditional IRA withdrawals made before 59½ — there's no distinction between contributions and earnings.

401(k) Withdrawal

There are two types: early and hardship withdrawals. Either way, you'll always owe income taxes. Although you won't owe a penalty for an early withdrawal if you leave your job after age 55, you typically owe a penalty for hardship withdrawals. Here are the details.

Early withdrawals are allowed without penalty if you meet any of the following criteria:

- You are 55 or older and leave your job.
- You're permanently disabled.
- Your medical debts exceed 7.5 percent of your income.
- You receive a court order to pay the money to your divorced spouse or a dependent.

Hardship withdrawals are subject to tax and typically subject to the 10 percent penalty. Your company must define its criteria for "hardship," which means you probably won't be able to qualify if you want the 401(k) money just to go on vacation or to buy a car.

In general, 401(k) hardship withdrawals are allowed if you'll use the money for:

- Buying a primary home
- Medical expenses for yourself, spouse, or dependents
- College tuition, fees and room and board for yourself, spouse, or dependents
- Payments to avoid eviction from foreclosure on your primary residence
- Funeral expenses

If your company allows hardship withdrawals, it may either require proof that you have a real financial need or prohibit you from making contributions to your 401(k) for six months after taking the withdrawal.

Worth Tapping Retirement Cash?

Below are four common reasons you might want to tap into your retirement accounts, and what financial advisors say about each:

Midcareer tuition bills

If you expect a degree will land you a high-paying gig that will get your retirement savings back on track later, it might pay to take this calculated risk with your retirement nest egg now. "Investments in human capital can return in the double digits," says Milevsky. "So it might make sense to forfeit the smaller returns in your 401(k) or IRA if there weren't any other sources of funds that were cheaper."

Before making a retirement plan withdrawal, estimate how big a hit you'd take. If you take an early withdrawal from a 401(k) plan for tuition, you'll be hit with tax plus 10 percent penalty, while an early withdrawal from an IRA would incur a tax hit but no early withdrawal penalty. So if you have a 401(k) from a previous job, roll it over first into an IRA and then withdraw from it.

If you're single and unemployed with no other income, your tax penalty is unlikely to be high," since it is based on your tax bracket, says Erika Safran, a principal at Safran Wealth Advisors, a fee-only financial advisory firm in New York City. "But a married working couple is often losing 40 percent of that asset after taxes are paid." A married couple in the 35 percent bracket withdrawing \$100,000 from a retirement account, for example, would probably be left with less than \$60,000 after taxes and penalties.

Your child's college tuition

Bad idea. When it comes to choosing between tuition and your own retirement security, don't feel bad telling your kid he's on his own. Otherwise you'll both regret the decision when you end up asking for financial support in your 70s. "If you're in your mid-40s and you take retirement money out for your child's education, you may never be able to catch up," says Mark Flaherty, a certified financial planner at Virginia Asset Management in Norfolk, Va. Your children can work their way through school, take out student loans, seek scholarships, or delay college, if necessary.

Down payment

If you just need cash to tide you over until you get money from the impending sale of your house, you're in luck. While IRAs technically don't allow loans, there's a back-door way to get a free temporary loan through what's called the "60-day rule." When you make an IRA early withdrawal, you have 60 days to open a new IRA account and roll the withdrawn money into the new plan without tax, penalty or interest.

If you need the money for longer than 60 days, you can withdraw up to \$10,000 penalty-free to buy a house as long as neither you nor your spouse owned a home for the past two years. Your spouse can withdraw \$10,000, too.

Starting a business

In most cases, this is far too risky for tapping your retirement money. "We know most new businesses fail, so you'd hate to see someone take money out of a retirement plan, pay the penalty, take the tax hit, and go into a highly speculative new venture," says Solin.

However, if you're committed to the idea of funding a business with retirement money, investigate a little-known strategy called Roll Overs as Business Startups (ROBS). Essentially, it lets you turn your 401(k) or IRA into stock of a new company.

Tired of the corporate world, Jim Guzdziol, 53, of Chicago, left his job as a vice president of merchandising at Sears Roebuck last year and used ROBS to buy a home health care franchise called Bright Star. With the help of BeneTrends, an Atlanta-based firm, Guzdziol withdrew nearly half his 401(k) money to do it, incurring no taxes or penalties, and leveraging his pre-tax dollars. "When you use savings or home equity to invest in the stock of your own company, you're investing post-tax dollars," says Larry Carnell, vice president of BeneTrends. "When you invest your 401(k) money, which is pre-tax, it's like the government has assumed 30 to 40 percent of the financial investment."

The business's growth exceeded Guzdziol's expectations, so he was encouraged to take the rest of his Sears 401(k) and purchase a second franchise. "My plan is to run the businesses full time until I'm 60, then hopefully step back and have time to enjoy our lakefront property in North Carolina with my family," he says.

Just tread carefully before employing this strategy: ROBS conversions are subject to complex IRS regulations. Be sure to seek advice from an attorney.

3 Alternatives to Tapping Your Retirement Funds

- **Home equity line of credit:** If you still have some equity and an excellent credit score, you'll pay about 5 percent, according to **Bankrate.com**.
- **Cash value life insurance:** You can take out a loan against up to 90 percent of its cash value and the interest rate will probably be lower than a bank loan. You decide how much to pay back and when. Whatever amount you don't pay back will be subtracted from the policy's payout when you die.
- **Friends and family:** Your rich uncle, parents or even successful adult children might have the wherewithal to give you a low-interest loan. Just make sure you lay out very specific terms, write them down, and stick to them — or Thanksgiving will never be the same.