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Money Essentials

401(k)s: Early withdrawals and loans

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When faced with a sudden cash crunch, it can be tempting to tap your 401(k). More than a few individuals have raided their retirement account for everything from medical emergencies to a week-long vacation.

But if you're under 59-1/2, keep in mind that an early withdrawal from your 401(k) will cost you dearly. You're robbing your future piggy bank to solve problems in the present.

You'll miss the compounded earnings you'd otherwise receive, you'll likely get stuck with early withdrawal penalties, and you'll certainly have to pay income tax on the amount withdrawn to Uncle Sam.

If you absolutely must draw from your 401(k) before 59-1/2, and emergencies do crop up, there are a few ways it can be done.

Hardship withdrawals

You are allowed to make withdrawals, for example, for certain qualified hardships -- though you'll probably still face a 10% early withdrawal penalty if you're under 59-1/2, plus owe ordinary income taxes. Comb the fine print in your 401(k) plan prospectus. It will spell out what qualifies as a hardship.

Although every plan varies, that may include withdrawals after the onset of sudden disability, money for the purchase of a first home, money for burial or funeral costs, money for repair of damages to your principal residence, money for payment of higher education expenses, money for payments necessary to prevent eviction or foreclosure, and money for certain medical expenses that aren't reimbursed by your insurer.

Loans

Most major companies also offer a loan provision on their 401(k) plans that allow you to borrow against your account and repay yourself with interest.

Restrictions will vary by company but most let you withdraw no more than 50% of your vested account value as a loan. You can use 401(k) loan money for anything at all.

You then repay the loan with interest, through deductions taken directly from your paychecks.

Borrowing from your 401(k), if you absolutely must, is a cost-effective way to obtain a loan, since you're borrowing your own money and paying it back with low interest. Because it's your money, you won't have to undergo extensive credit checks, either.

But there are disadvantages, too. First and foremost, you're robbing your future. Though you may repay the money you withdraw, you lose the compounded interest you would have received had the money just sat in your account.

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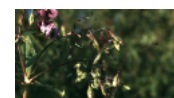
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And some companies restrict you from continuing to contribute to your 401(k) while you're paying back a loan, which could force you to miss out on even more money.

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The whole situation becomes more precarious if you leave the company. Whether you quit, get fired, or are laid off, the loan becomes immediately due. Before you take out a 401(k) loan, you need to consider what would happen if you found yourself out of a job and with an imminent loan on your hands at the same time.

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72(t) withdrawals

Finally, you may be able to withdraw without penalty under IRS rule 72(t), which allows you to withdraw a fixed amount based on your life expectancy.

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Under the 72(t) rule, you must take withdrawals for at least 5 years or until you reach age 59-1/2, whichever is longer. If you're 56 and poised to retire, for example, you'll get a specified amount every year for 5 years, until you're 61. But if you're 52, you'll get your specified amount every year for 7-1/2 years, until you're 59-1/2.

It isn't an entirely free ride, though. Although you do avoid the 10% early withdrawal penalty, you still pay taxes on the amount you tapped. You still lose compounded earnings you'd otherwise have if you let the money grow.

And if you choose 72(t) payments when you're much younger than 59-1/2, the deal you get isn't as good. Someone who began 72(t) withdrawals at age 40, for example, would only get a small amount (because her life expectancy is long) every year, and pay income taxes on it for the next 19-1/2 years.

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