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The Cost of Untimely Retirement Plan Distributions

When you are faced with needing cash quickly, or have an unexpected expense, you may be tempted to take an early withdrawal or borrow funds from your employer-sponsored retirement plan account (if your plan allows it). Be aware that the convenience of taking untimely distributions (loans, early withdrawals, hardship distributions, etc.) could come with significant consequences on your short and long-term goals.

Four Reasons to Reconsider Taking Money Out of Your Employer-Sponsored Retirement Plan:

1) Taxes and Fees

Most retirement plan distributions are generally taxed as ordinary income and may be subject to an additional 10% tax for “early” distributions (before 59 ½) if they don’t meet any of the IRS exceptions. If you take a retirement plan loan, it initially could cost around $100 -150 dollars (on average) in origination and ongoing maintenance fees. This could be very impactful if your loan is smaller - a $1,500 loan could have 10% in fees.

A Note on Loan Repayments:
When you take a loan from your retirement plan, repayments are made with after-tax dollars. This means:

- If your original contributions were pre-tax, you’ll pay taxes again when you withdraw those funds in retirement – resulting in ***double taxation.***
- If your original contributions were Roth (after-tax), you’re paying taxes both when contributing and again when repaying the loan – also a form of ***double taxation***.

In either case, you’re ***taxed twice*** on the same money. This is an important cost to consider before taking a loan from your retirement plan.

2) Less Contributions Long-Term

There is a correlation between taking out retirement plan loans or distributions and contributing less overall to the retirement plan. T.Rowe Price discovered that people who borrowed frequently from their retirement plan accounts had lower savings rates – by 2.3 percentage points, on average—than those who rarely, or did not, borrow from their accounts. This could mean that those who tend to borrow or withdraw often don’t have the extra income to be able to contribute larger amounts to their retirement savings, which could have a big impact on meeting their long-term retirement goals.

3) Losing Out On Potential Investment Return

Borrowing from your retirement plan – or making early withdrawals – can significantly reduce your long-term savings potential. Even if you repay yourself over time, you lose out on the opportunity for compound growth on the borrowed amount.

A study by T. Rowe Price found that employees who took more than two loans per year had account balances that were 60% lower than those who never borrowed – despite having similar ages and job tenures. Why? Because the money removed from the account wasn’t invested and growing.

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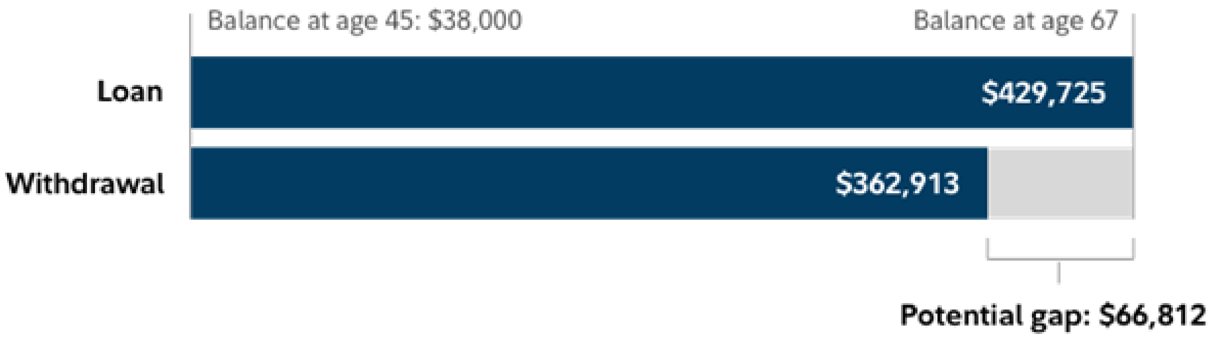
As a result, frequent borrowers are far less likely to benefit from long-term investment returns like their peers who left their savings untouched.



In this hypothetical withdrawal scenario, a total of $23,810 is taken from the account so that 37% ($8,810) of the withdrawal is set aside for taxes and penalties and the remaining amount ($15,000) is received, leaving $14,190 in remaining balance at age 45. The hypothetical 22-year time frame between ages 45 and 67, assumes an annual income of $75,000 with a 1.5% increase yearly, a personal rate of return of 4.5%, an employee contribution amount of 5%, and an employer contribution amount of 5%. For illustrative purposes only. All calculations are estimates and should not be relied upon for detailed planning purposes. This example is hypothetical and does not represent the performance of a particular investment.

4) Risk of Loan Penalties

If you're unable to repay your retirement plan loan, the outstanding balance is considered defaulted. In that case, the balance becomes a taxable distribution, and if you're under the age 59½, you may also owe a 10% early withdrawal penalty.

If you leave your job, any unpaid loan balance typically must be repaid by the end of the calendar year. Otherwise, it will be treated as defaulted. This can lead to an unexpected tax bill and reduce your retirement savings—potentially creating long-term financial setbacks.

Alternative Solutions:

No one contributes to a company retirement account expecting to use their hard-earned savings before retirement. However, we all know that things happen in our life that we often don't expect. That is why having emergency savings set aside is important.

The Value of an Emergency Fund

One of the primary reasons to have an emergency fund is to keep your financial and savings goals on track should something unexpected happen. Having this fund handy can save you from having to dip into your retirement savings or get cash through high-interest loans. Try working up to save $1,000 as a starting point. From there, continue to build your emergency savings account until it reaches 3-6 months of expenses.

Credit Counseling

The inability to cover life's sudden, and often unforeseen, costs can end up damaging your chances for a comfortable retirement. If you feel overwhelmed, or faced with an emergency expense, consider working with a nonprofit credit counseling agency.

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When faced with the temptation to borrow funds or take an early withdrawal from your employer-sponsored retirement plan account, weigh the risks to your long-term goals – looking at alternative options can preserve your retirement savings and provide greater peace of mind.

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