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# When It's OK to Plunder a 401(k) Before You Retire

By KAREN BLUMENTHAL

That little drip, drip, drip you hear might be money leaking from your retirement account.

Jon Reinfurt

In a report last week, the budgeting website HelloWallet estimated that about one-fourth of all households have tapped a 401(k) or similar account for needs unrelated to retirement, a trend it attributes to Americans' inability to put cash aside for a rainy day.

Between hardship withdrawals, cash-out distributions and loans, roughly $60 billion to $70 billion each year will leak out of 401(k)s and other defined-contribution plans held by account holders under the initial withdrawal age of 59½ years old, HelloWallet and other analysts estimate.

That might not be such a terrible thing.

For starters, the total is less than 2% of the $4.5 trillion now socked away in employer-sponsored accounts, which include plans offered to nonprofit and government employees. In addition, people might be reluctant to save at all in retirement accounts unless they know they can get access to their money before retirement if they need to.

And sometimes there are good reasons to tap your account.

"One person's leakage is another person's safety valve," says Steve Utkus, director of the Vanguard Center for Retirement Research, an arm of financial-services giant Vanguard Group.

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To be sure, borrowing from or cleaning out your account can come with consequences, the most dire being that you won't have enough money to live on during retirement.

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Ideally, you would have an emergency cash fund and the financial flexibility to avoid touching your 401(k) money until retirement. But that can be a challenge for young people just starting out or people who have lost jobs or face serious health issues.

For many people, the retirement account could be their biggest source of savings. In that case, it also can be de facto unemployment insurance or the best way to pay for a house down payment or tuition.

For such people, the 401(k) becomes a "one-size-fits-all rainy-day fund," says David Laibson, a Harvard University economist. Here's the catch, he says: That means "you've got to save more in the first place" so that the fund can still provide for you in retirement.

Thinking about tapping your retirement funds? Here is what to consider:

**Loans.** In plans that allow borrowing, about 21% of participants had outstanding loans in 2011, up from 18% in 2008, according to a December report from the Employee Benefit Research Institute. While participants can borrow up to half of their account, up to a maximum of $50,000, the average loan amount owed in 2011 was $7,027, down from $7,191 in 2008.

Financial planners generally discourage such borrowing, in part because you lose out on any appreciation that the money might earn. And if you lose your job, you have to repay your loan, typically within 60 days, or else pay income taxes and a 10% tax penalty on the money.

To discourage willy-nilly borrowing, some employers are beginning to limit workers to one or two loans at a time, instead of several, and some companies are adding fees of $50 to $100 to cover administrative costs, says Michael Falcon, head of retirement at the J.P. Morgan Asset Management unit of J.P. Morgan Chase .

Still, the vast majority of loans are repaid, and you will pay yourself interest, often at the prime rate plus one percentage point, or 4.25%.

That isn't a good reason to borrow for a wedding or vacation, but it might make sense for those who borrow judiciously for something that is an investment, such as a house, education or eliminating high-cost debt to free up more savings.

**Hardship withdrawals.** Federal regulations allow hardship withdrawals for specific reasons —primarily to avoid foreclosure or pay for medical expenses, a funeral or a college education. The participant must prove the need, says Beth McHugh, Fidelity Investments' vice president of market insights. The withdrawals also can be used to purchase a primary residence.

Unlike loans, these funds aren't repaid. Eleanor Blayney, the Certified Financial Planners board's consumer advocate, cautions that someone in such a difficult situation should consult a credit counselor or financial adviser first. Foreclosure or bankruptcy might be a better choice, she says, partly because 401(k) funds are protected in a bankruptcy proceeding.

**Cashing out.** The biggest source of leakage comes from job changes, when people take a check instead of leaving money in the plan or rolling it over to an individual retirement account or another plan. According to consultants Aon Hewitt, about 40% of participants take cash when they leave a job, meaning they will have to pay income taxes and the 10% tax penalty.

While that is a large percentage, the balances usually are small. In dollar terms, only 7% is cashed out.

Young people are especially likely to take a check, and that might make sense if it is used to better their long-term situation, such as paying for school or reducing debt. Still, keep in mind that while the check may be just $2,000 today, it could grow to $43,500 over a 40-year career, assuming an 8% annual return.

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