The Basics on Hardship Withdrawals, Loans and Job Changes

Chapter Nine

Have you ever wondered why loans and hardship withdrawals exist in a retirement plan? Permitting participants to borrow or withdraw from their retirement accounts seems counterproductive when we so frequently hear that Americans are not saving enough money for retirement.

But many believe that loans and hardship withdrawals actually lead to increased retirement savings. They claim that many younger and lower-paid employees will not contribute to a 401(k) if all their money is locked up until retirement age. Without question, 25-year-olds have many financial needs other than saving for retirement. It's tough for most employees who earn less than $20,000 to find any money to contribute to a 401(k). The opportunity to access these savings when necessary does help to increase participation among lower-paid employees, particularly when there isn't an employer contribution incentive.

Although loans and hardship withdrawals increase the appeal of the 401(k), they are not required plan features. Check your Summary Plan Description for your plan's loan and hardship withdrawal provisions.

Hardship Withdrawals

Virtually all 401(k) plans permit hardship withdrawals; however, the applicable IRS rules must be followed to avoid a plan disqualification. Withdrawals are permitted only when there

is an immediate and heavy financial need. There are two different approaches to determining this need: the “facts and circumstances” test and the “deemed hardship” method.

Employers are required to obtain substantial personal financial data to determine the extent of the need for the facts and circumstances test. Among other things, the participant must show that no other resources are available, including loans from commercial sources. The requirements are so extensive and invasive that most employers choose the deemed hardship method.

With the deemed hardship method, withdrawals are limited to this IRS approved list:

- Medical expenses for you, your spouse or dependents not covered by insurance
- Costs related to the purchase of your primary residence
- Payment of post-secondary tuition and related educational expenses for the next 12 months for you, your spouse, a dependent or non-dependent children
- Payments necessary to prevent either eviction from your principal residence or foreclosure on the mortgage on that residence.

In addition, you are subject to the following restrictions:

- The distribution cannot exceed the amount you need (including taxes)
- You must obtain all distributions of non-taxable loans under all plans of the employer.
- Your maximum contribution amount during the year of the withdrawal and the following year is equal to the annual contribution limit
- You may not make any contributions to the plan for at least the next six months following the date you receive the withdrawal (effective in 2002).

Plans that use the deemed hardship approach don’t have to ask participants for personal financial data to show that no other resources are available. The government thinks the tax burden plus the other penalties are sufficiently draconian so that no participant of sound mind would withdraw the money unless there really is an immediate and heavy financial need.

This whole issue of restricted access commonly confuses participants: “Why can’t I take out *my* money anytime?” The answer is that the government gives you big tax breaks to help you save. They really want you to use this money when you retire. They could have written the law so there isn’t any way to get your money out prior to retirement (similar to Social Security). But they opted for limited access instead.

A hardship withdrawal reduces the maximum amount you can contribute to the plan the year after you take the withdrawal. To illustrate this, assume you:

- take a hardship withdrawal on May 14, 2002
- have contributed $4,500 of pre-tax contributions during 2002 prior to the withdrawal
- start to contribute again on January 1, 2003.

The dollar limit for pre-tax contributions is $12,000 for 2003. Your contributions for 2003 will be limited to a maximum of $7,500 ($12,000 minus $4,500).

The amount you can withdraw for a hardship may be limited to just your contributions excluding investment gains, or you also may be able to withdraw vested employer contributions. This is another example where the employer establishes the rules. I usually advise employers to permit only the withdrawal of employee contributions, because your employer is making its contribution to help you retire.

In addition to hardship withdrawals while you are still employed, you can withdraw your entire account any time after age 59 ½ if your plan permits you to do so. A withdrawal after this age can be made for any reason, including rolling the money into an IRA.

The amount you withdraw is taxable as additional income and the 10% early distribution penalty tax applies if you are under age 59½. You may get

a tax break if the withdrawal is for medical purposes. I have received questions from participants who think buying a home exempts them from the 10% penalty tax. This is not the case.

Participants who are unhappy with their 401(k) investments also frequently ask me if they can take their money out and roll it into an IRA. This is not considered a hardship withdrawal. You can transfer your money to an IRA only if you are over age 59½ or if you leave your employer and your plan permits you to take the money out.

Unless participants elect out of tax withholding, hardship withdrawals are subject to a 10% tax withholding—rather than the standard 20% withholding.

The mandatory tax withholding has no relationship to the amount of Federal and state tax you will owe when you take money out of the 401(k) for a hardship or for any other reason. The taxes that are withheld are simply a deposit to the IRS. The actual tax due will be determined when you compute your taxes for the year during which you receive the distribution.

Assume your taxable income for 2003 is $45,000 prior to your $10,000 401(k) hardship withdrawal. The $10,000 is added to the $45,000 to make your total income $55,000, which is taxed at the applicable tax rate. You then pay the 10% penalty tax, which is $1,000. Typically 25% to 40% of the amount withdrawn is paid in taxes. If your tax rate is 27%, you need to add the 10% penalty tax and withdraw $15,873 to have $10,000 left after paying Federal and state taxes. You are not likely to have the money sitting around to pay the $5,873 in taxes, so you will probably have to take it out of the plan. This is the first level of tax pain.

The next level of pain is the disruption in your retirement savings. You didn't just lose the $15,873. You lost what this money would be worth by the time you retire. The following example illustrates this loss:

Cost of Withdrawing $15,873 Early

Age on Date of Withdrawal	Lost Value at age 65
55	$37,577
45	88,959
35	210,598
25	498,562

Assuming a 9% investment return

Using Your 401(k) Money to Buy Your First Home

The tax bite and the disruption to your retirement account are two good reasons to avoid a hardship withdrawal unless it is absolutely necessary. But withdrawing money to buy your first home can be a smart financial decision. The first and most obvious point is that buying a home is a better long-term financial deal for most families than renting. Assume you take a hardship withdrawal of $15,000 to buy a $180,000 home with a 30-year mortgage when you are 35. Your goal should be to pay the mortgage off before you hit retirement age. Assume the value of your home appreciates at a rate of 3% per year. It will be worth $435,600 after 30 years. As I explain in Chapter 10, a house can be turned into a valuable liquid asset if you someday find that your retirement nest egg isn't sufficient.

You may be wondering what would have happened to that $15,000 if it had been left in your 401(k) plan. If the $15,000 earned a 9% return until your retirement age of 65, it would have grown to $199,000. This shows the value of home ownership—the same $15,000 invested in a home more than doubles your return. You will, of course, need to put additional money into your home for repairs and maintenance over the years, but you should still be ahead of the game.

It's worth mentioning that these dramatic investment returns are most likely when you are buying your first home. If later in life you withdraw $40,000 from your 401(k) to upgrade from a $200,000 home to a $500,000 home, you will likely lose in two ways. First, this larger withdrawal drills a larger hole in your nest egg that is difficult to replace in fewer years. The second reason is that you likely have fewer years to pay off the $500,000 home, build equity and see your $40,000 investment appreciate in value.

If you are using your 401(k) money to purchase your first home, there's a smart approach to either eliminate or substantially reduce your tax bite. First, you need to time the withdrawal and the home purchase so both occur as close to January 1st as possible. Assume the following facts:

- You are buying your first home for $180,000
- You have to withdraw $15,000 to help cover the initial costs
- The property taxes are $4,000 per year
- The mortgage will be $162,000 at a 6.5% interest rate
- The settlement date is January 15th.

The property taxes you'll pay will be approximately $3,800 and the mortgage interest will be approximately $10,100 in the year you buy the home. This is because you will own it for only 11.5 months. You will start to receive the tax benefits of first time home ownership by deducting the interest and taxes. This combination will give you $13,900 of deductions to largely offset the impact of having to add the $15,000 withdrawal from your 401(k) to your total income.

But this only works if you withdraw the $15,000 during the same year you buy the home. The benefit diminishes the later in the year you buy the home because you have to include the full withdrawal in your income, but you only have interest and tax payments for the period you own the home. The worst possible result is to buy your home in December, because you would only get the tax break related to home ownership for part of one month. In this case a $15,000 taxable distribution less a $1,000 tax break means $14,000 is taxable.

401(k) Loans

Loans are also legally permitted but not required plan features. They're difficult to administer, which is the primary reason they're not offered by many employers. I've always advised employers to exclude loans until the plan is a few years old. New plan sponsors have their hands full with many other plan administrative matters.

The process of getting a loan has been streamlined and expedited through online services, but the repayment process is still very difficult. The most common way to repay a loan is through payroll deductions. This is obviously much more cost-effective than submitting a personal check each month. One of the challenges of the payroll deduction repayment is calculating the right amount each month. This is difficult when the number of pay periods varies in some months of the year. There may be three pay periods some months instead of two, or five instead of four.

Another problem with payroll deduction repayments is that it becomes impossible to continue repaying the loan after you leave your employer. When this happens, the entire amount of the unpaid loan becomes taxable, unless you are able it pay it off. Few employees are able to pay off the loan since they have used the money for some other purpose.

If you have a $6,000 unpaid loan balance when you leave your employer and you are unable to repay it, you will have to pay tax on this amount. The 10% early distribution tax will be applied in addition to the regular tax if you are under age 59½. This is why it's wise to stay with your employer until the loan is repaid.

Similar to hardship withdrawals, loans must also satisfy all applicable laws and regulations. The following are some of the major items you face:

VerB,C,D-p1-16,41-134 GEN 3/16/04 10:37 AM Page 109

- The amount you can borrow is limited to 50% of your vested benefit (from both employer and employee contributions), and $50,000 is the maximum. Some plans allow participants to borrow up to $10,000 without any percentage limit.
- The loan must normally be repaid within five years. A longer period may be allowed if the money is used to purchase a home.
- You must pay a reasonable rate of interest, typically the prime rate plus one or two percentage points.
- Your loan must be adequately secured, typically by your vested account balance.
- The loan must be for a reason specified in the plan document.

Your employer can structure the plan to permit borrowing for any reason or for only specific reasons. A common approach is to permit loans only for the reasons that are included on the hardship withdrawal list. You can get the specific details about loans in your Summary Plan Description or from your plan administrator.

The most attractive feature of a loan is that it isn't taxable when you receive the money. This is a way to get your hands on some of your retirement money without having to immediately pay income tax or the 10% early distribution penalty tax. While this may seem to be a great deal, it really isn't because you have to repay both the loan and interest with after-tax deductions from your paycheck. As a result, you really do pay tax on the loan. You just pay it every pay period rather than in a lump sum.

Assume you borrow $10,000 that you will repay with interest at 8% over a five-year period. The monthly deductions from your pay will be $202.76. The total amount you will repay is $12,166, including interest. But you must also pay tax on this money before you start to make the loan payments. You will also pay Social Security and state and local income/wage taxes in addition to the applicable income taxes at this time. And, by the way, you will pay tax again on this same money after you repay the loan and the money is later withdrawn as a plan benefit.

By the time the $10,000 loan is repaid it has cost you $18,617, assuming a 27% Federal income tax rate, the 7.65% Social Security tax and any applicable state and local income/wage taxes. This is the breakdown:

Loan to be repaid	**$10,000**
Interest on loan	2,166
Federal income tax (27%)	5,027
Social Security (7.65%)	1,424
Total cost	**$18,617**

On page 115 I explained that it costs you $15,873 to get $10,000 net of taxes out of the plan with a hardship withdrawal. It costs you $18,617 to repay a $10,000 loan. I know the $2,166 of interest goes back into your account reducing the net cost to $16,451, but this still doesn't make a loan a better deal. I realize you have to repay other loans with after-tax money, but I'm not comparing 401(k) loans to other loans. I'm comparing 401(k) loans to hardship withdrawals. With a hardship withdrawal you must stop contributing for six months, but this also is better than missing five years of contributions if you can't afford to repay your loan and continue to contribute. (I have ignored state and local teaxes in these examples to avoid making an already complex analysis even more complex).

The bottom line is that both loans and hardship withdrawals are much less attractive than they first appear. As a result, they should be used only when absolutely necessary, rather than as a convenience. And remember that there's an advantage to the hardship withdrawal if you will lose employer contributions while you repay a loan.

As you can see in the example on page 118, your retirement savings plan will be seriously dis-

VerB,C,D-p1-16,41-134 GEN 3/16/04 10:37 AM Page 110

Example of How a $10,000 Loan Can Cost You Over $100,000

One of the biggest risks when you borrow from your 401(k) is that you will not be able to repay the loan and continue to contribute to the plan. The following example illustrates this point. Assume:

- A 35-year-old employee, Rob, has been contributing $1,800 and receives $900 of employer matching contributions per year.
- Rob decides to borrow $10,000 from his 401(k).
- The loan repayment is $207.58 per month or $2,490.96 per year for five years using a 9% loan interest rate.
- Rob is earning a 9% annual return on the amount he has invested in the 401(k) plan.
- There is a 50% employer match.

Rob cannot afford to repay the loan and continue to contribute to the plan. So, he stops contributing during the five-year period the loan is being repaid. This creates a lost opportunity that is much bigger than the $9,000 he would have contributed during this five-year period. Rob will also lose $4,500 of employer matching contributions. Even more importantly, had these additional contributions been invested in the plan earning 9% until age 65, they would have grown to $139,340.

rupted if you can't continue your plan contributions while you are repaying your loan.

A 401(k) loan is attractive only if you can't get a commercial loan at a similar interest rate. Of course, borrowing from yourself at 8% is a lot better than paying 22% to a credit card company. You should cut up your credit cards if you need to borrow from your 401(k) to pay off credit card debt.

I had to borrow from my 401(k) when my wife Ellie and I were struggling to handle four tuition payments at the same time. Although it was difficult, I continued to contribute 6% of my pay while I was repaying the loans, because I didn't want to lose the 50% employer matching contribution during those years. I certainly know that borrowing from your 401(k) can be a lifesaver under the right circumstances.

Warning for Employers

Employers must administer hardship withdrawals and loans according to the plan document and the applicable regulations. Not long ago a controller told me his company permits hardship withdrawals for any reason. This approach may make some of your participants happy, but it will lead to big trouble if your plan is audited by the IRS or DOL. The primary penalty for violating the law is to disqualify your plan, which will create major tax problems for your company and all participants. The company will lose the tax deductions it has received and employees will lose the benefits that come with a qualified plan, such as the tax-deferral for investment earnings and the opportunity to roll the money over to an IRA.

Both the IRS and the DOL are likely to review both your hardship withdrawal and loan procedures if they audit your plan. You should retain the application and other paperwork for each hardship withdrawal. I strongly recommend getting some documentation from the participant to support the reason for the withdrawal. For example, get a copy of the contract if the participant is buying a home. The loan application should include a computation that shows that the amount of the loan doesn't exceed the applicable limits. You should also have any paperwork showing the loan approval.

The streamlined processing offered by many service providers for hardship withdrawals and loans may make both these transactions faster and easier for your participants, but you are still required to follow the procedures that are outlined in your plan document. A few years ago one of my clients was audited by the DOL. The agent spent weeks on-site going through all the employer's files. Subsequently, the agent sent a letter to the CFO citing a loan violation. The amount that one participant borrowed supposedly exceeded the 50% limit. The CFO was very

upset when he called me, because my firm had computed the loan amount and the letter from the DOL made it sound like this company had committed a horrible crime. We discovered the agent was wrong and we were right—but it was a big hassle to get to that point. Incidentally, my client didn't receive an apology letter after the agent was informed of his error.

You should operate your plan with the awareness that these audits do occur and they are not fun. The agent involved will probably also check to see that your plan's eligibility, vesting, loan and hardship withdrawal provisions are being followed as they are defined in the plan document. Not to mention a check of your compliance tests, Form 5500 filings, timing of plan contributions and investments. It's an exhaustive process that takes you away from important business: do everything that you can to avoid an audit.

When You Change Jobs

Studies show that roughly one-third of all participants invade their retirement savings when they change jobs. Smaller balances are less likely to be rolled over into a new plan, primarily because participants don't understand the long-term impact. Unless you have a serious financial necessity, I'd resist any temptation to spend any amount of your retirement savings.

You might think that spending $5,000 or $10,000 of your 401(k) money won't make a big difference in your retirement savings. As the withdrawal example on page 115 shows, it will make a lot of difference. Blowing $10,000 of your retirement money at age 35 will cause you to have $132,677 less at age 65, assuming a 9% investment return. You'll forfeit $157,047 if you take out $5,000 at age 25.

When you change jobs, your former employer cannot force you to take your money out of the plan, if the value of your vested benefit exceeds $5,000. This includes your contributions plus earnings and any vested employer contributions plus earnings. After you terminate your employment, your former employer is supposed to give you a written explanation of your options.

Some employers fail to inform employees of the option to leave their money in the plan. The money can be left in your former employer's plan until the normal retirement age specified in the plan document, usually age 65. A forced distribution is permitted at that time, regardless of your account size. Many participants want to get the money out of the plan as soon as they can. Others who are too busy, don't like making decisions, or really like the investment options tend to let the money sit. Both are much better alternatives than just taking the money out and spending it. In any case, you probably will not be able to move the money into your new employer's plan until you are eligible to make contributions.

Regardless of the amount of your benefit, you can transfer the money directly to your next employer's plan or into an IRA. An IRA transfer should be made directly from your 401(k) to the IRA. If the money comes directly to you, your employer will be required to withhold 20% and deposit it with the IRS. In this case, you will still be able to roll over the entire amount, but you will have to make up the 20% penalty by using other funds. You have 60 days to complete a rollover once you receive your benefit payment. The IRS is very firm about this date, so you need to be careful.

This 60-day time limit is applicable only when you receive a distribution directly. There isn't any time limit for rolling your money over from the 401(k) to an IRA or into another plan. For example, you can leave your money in your former employer's plan for several years before you transfer it to an IRA or another employer plan.

I left my 401(k) money in my former employer's plan because I was comfortable with the way it was invested. I decided to transfer it to an IRA when the company was sold a year later because I didn't like the new funds. One of the risks when

VerB,C,D-p1-16,41-134 GEN 3/16/04 10:37 AM Page 112

you leave your money in the plan is that your former employer can change investment funds. Your money is automatically transferred to the new funds without your approval.

When you leave your money in your former employer's plan you could also have trouble collecting the benefit later. The company may go out of business, be sold, or the employees who oversee the plan could be focused on more urgent matters. For this reason, I recommend transferring your money as soon as you can so that you'll have more control. In most instances, the same investments you have in the 401(k) are available for an IRA—and an IRA offers thousands of other alternatives.

Knowing what to do with the 401(k) money you accumulated in your former plan is not the only major issue. There's also the problem of keeping up with your savings while you're waiting for your new plan eligibility to kick in. There will likely be a period when you can't make any 401(k) contributions, and you'll temporarily see more money in your paycheck. My first advice is not to lose the savings habit—don't spend the extra money. If you get used to spending more money, you won't easily get back to your prior savings level once you're in the new plan.

To continue to save at your prior rate, use a tax-favored regular or Roth IRA. If you're not eligible for an IRA, or if the amount you want to save exceeds the IRA limit, set up a personal mutual fund account or other investment account. Because some or all of your savings will have to come from your after-tax pay, you may not be able to save as much as you did before. You also won't be receiving any employer contributions during this period. As a result, you should try to save as much or more than the amount you were saving before you changed jobs—particularly if your salary has increased.

Another possibility is to temporarily put your savings into a money market fund until you are able to join the plan. This would allow you to contribute a larger amount of money once you do join the plan. Assume you previously contributed $3,000 per year pre-tax to a 401(k), you have been earning $40,000 and you won't be able to contribute to your new employer's plan for one year. Put the after-tax amount, $2,400, into a money market fund. Increase your contributions to $6,000 the first year you are in the new plan and use the $2,400 you have stashed away in the money market fund to offset the increased 401(k) contribution. This approach will enable you to recover the tax benefits you lost while you weren't eligible to join the new plan. I recommend this solution if you aren't able to make deductible contributions to an IRA.

Tips on Hardship Withdrawals, Loans and Job Changes

- *Consider the real costs of both loans and hardship withdrawals—in dollar and plan contribution terms.*
- *To avoid or greatly reduce the tax sting when you buy your first home, plan ahead so that the hardship withdrawal and the home purchase both occur early in the year.*
- *Don't use your 401(k) money for non-retirement purposes when you change jobs.*
- *Keep up your savings pace while you're waiting to join your new employer's plan.*
- *If you are an employer, maintain loan and hardship withdrawal records in case of an IRS or DOL audit.*
- *Remember, loans are not tax-free money.*