

TAPPING INTO RETIREMENT ACCOUNTS EARLIER THAN ANTICIPATED

The economic downturn and persistent high unemployment have led to an alarming, though perhaps inevitable, rise of people tapping into retirement funds before intended. During the second quarter, 62,000 of the 11 million workers using 401(k) plans provided through Fidelity began the process of taking out a hardship withdrawal, up from 45,000 during the first quarter, according to the survey by Fidelity Investments, the largest administrator of retirement plans in the U.S. That increase lifted the total percentage of active Fidelity 401(k) plan participants who had taken out a hardship withdrawal to 2.2%, up from 2.0% a year ago. The most common reasons participants cited for taking out a hardship withdrawal were to stave off an eviction or foreclosure, to pay college tuition and to buy a primary residence.

Unfortunately, tapping into a retirement fund early comes with a price; if an investor withdraws money from an IRA, 401(k), 403(b) or another qualified retirement plan before reaching 59 1/2, the Internal Revenue Service generally imposes an early withdrawal penalty of 10% of the taxable amount withdrawn, in addition to the income tax owed on the withdrawal. Withdrawing earnings from a Roth IRA less than five years old can trigger comparable penalties. Depending on the investment, there are a few exceptions. Because tax laws change and 401(k) and 403(b) rules differ among plan administrators, people planning on making an early withdrawal should check the most up-to-date information about the rules for IRAs at IRS.gov and for 401(k)s and 403(b)s with their plan administrator.

Using funds in a retirement plan should be an absolute last resort should you find yourselves in a financial bind. Alternatives such as exhausting other lines of savings, taking out a home equity loan or even selling personal items should be done before considering a retirement plan distribution. However, recognizing that worst can come to worst, here are three options for accessing your retirement accounts responsibly:

1. Use a 401(k) loan

Most 401(k) plans and several other types of employer-sponsored plans allow investors to borrow up to half of the vested balance in their account, up to \$50,000.

More investors are turning to these loans. Over the twelve months ended last quarter, roughly 11% of the 11 million workers using 401(k) plans provided through Fidelity borrowed from those accounts, according to the Fidelity survey. That increase lifted the total percentage of Fidelity 401(k) plan participants with an outstanding loan against that investment to 22%, up from 20% a year ago.

The terms of 401(k) loans differ among plans, but most require borrowers to pay back the loan within five years. People who use the money to buy a home often get a longer repayment period. Most plans also set a minimum loan amount, usually about \$1,000.

Advantages: The 401(k) loan typically requires no credit check and minimal paperwork and places only a few restrictions on how consumers use the money. The loans often offer better interest rates than banks do, usually one or two points above prime, and the interest is tax-sheltered, so investors will not have to pay taxes on it until they withdraw it from their account. Because investors are paying the interest to themselves rather than to a third party, they pocket these payments. These loans are also exempt from the 10% early withdrawal penalty.

Disadvantages: Borrowing from a 401(k) is costly. Investments in a 401(k) are made with pre-tax dollars, but payments on a 401(k) loan are not. When investors withdraw that money in retirement, they will have to pay taxes on it again.

Many 401(k) loans have tough repayment conditions. For example, if a borrower leaves a job, she must pay back the loan in full within about 60 days or she will be charged the 10% penalty and forced to pay income tax on the amount withdrawn. Some 401(k) loans charge fees, and many offer little or no flexibil-

ity in the loan repayment schedule. The loans are not tax deductible.

2. Take Substantially Equal Periodic Payment (SEPP) distributions from an IRA

Investors are permitted to make regular withdrawals of equal amounts from their IRA over a predetermined period without paying the 10% early-withdrawal penalty (though income taxes are still owed on the amount withdrawn), provided they adhere to a schedule. Investors must take these payments, known as 72(t) distributions, at least once a year for a minimum of five years or until age 59 1/2, whichever takes longer. They must use one of three methods approved by the IRS for calculating the amount of these distributions — the amortization, life expectancy or annuity method - each of which uses life expectancy as a primary factor.

Advantages: The 72(t) distributions skirt the early withdrawal penalty and can provide a fixed, regular stream of income for an extended period of time. Investors with multiple IRAs can choose from which IRA they withdraw. If the investor withdraws from multiple accounts, he is free to use a different calculation method for each. The IRS also allows investors to switch their calculation method once during their 72(t) schedule.

Disadvantages: The IRS imposes tough penalties on investors who do not adhere to their 72(t) distribution schedule. Stop taking the withdrawals early or miscalculate the withdrawal amount, and the IRS may charge a 10% penalty not only on the most recent distribution but also on every withdrawal the investor has taken thus far.

Because the IRS offers limited ways to calculate distributions, some consumers find that 72(t) distributions do not provide them with enough money. Interest rates, which also play a role in determining distributions, are near historic lows, so 72(t) distributions may be especially light in coming months.

Also, the time commitment for the 72(t) distribution schedule is significant — every investor must commit to at least five years, and young people may have to commit for decades. Some hire a professional to navigate the complexities of the distributions. 72(t) distributions are a very complicated animal and should someone wish to go this route, using a professional experienced with setting up such distributions plans is highly recommended.

3. Tap a Roth IRA

The Roth IRA is among the most effective ways to save for retirement, but it also represents one of the easiest ways to tap retirement funds, so investors must weigh this ease of access against the long-term consequences.

Advantages: In the short-term, the Roth IRA option is one of the cheapest ways to dip into a retirement fund. Because contributions to the Roth IRA were made with after-tax money, consumers can make withdrawals of contributions, though not earnings, without paying penalties or taxes.

Most plans also make withdrawals fairly easy, and unlike the traditional IRA, Roth accounts have no minimum distribution or rules mandating age at the time of withdrawal, so investors can keep adding to the account as long as they are employed. This gives investors a longer time to replenish the funds they took from their Roth, as well as more opportunity for them to grow.

Disadvantages: The long-term impact of raiding a Roth IRA can be significant. Because investors contributed to that account using after-tax money, those contributions can grow for years, tax-free. When the investor turns 59 1/2, he can withdraw both the principal and the earnings tax-free. An early withdrawal limits that growth. Separately, if an investor under 59 1/2 withdraws the earnings from a Roth account less than five years old, he may have to pay a 10% penalty and taxes on those earnings.

PlanningPerspectives

Suite 315
39899 Balentine Drive
Newark, CA 94560-5359