The Examiner

401k Withdrawals: Avoid Taking Money Early, and Often

Examiner Media | Dec 10, 2014 |

By Peter Chieco

There is good news and bad news on the retirement front.

The good news is that the federal government now allows larger annual deposits into workplace retirement accounts such as 401(k) plans.

Workers under the age of 50 will be able to deposit up to $18,000 in 2015, an increase of $500 from this year, while those over 50 can boost their accounts by $1,000 more each year for a total of $24,000 annually.

On the bad news side, many plan participants are withdrawing from their retirement plans early and thereby significantly reducing, or in some cases entirely eliminating, the amount that ultimately will be available for retirement.

Some analysts believe that the most recent recession and the sluggish recovery may be driving factors in the raids on retirement accounts, especially among people who are out of work. One firm that specializes in retirement plans reported that 35 percent of its participants took out part or all of the money in their workplace retirement plans when leaving a job in 2013. Among those from ages 20 to 39, about 41 percent withdrew money.

It is apparent that retirement savings have become a cash flow asset for people who are experiencing financial difficulties. The raids on retirement funds also may have resulted from the housing crisis that peaked in the last decade, but still is affecting housing prices – and thus home equity – in many parts of the country.

Home equity increases the amount of money available through a home equity loan or a home equity line of credit for home improvements, medical bills, education or emergency expenses.

When home equity dries up, a ready source of cash for expenditures such as college educations, home improvements and emergencies goes with it. In those cases, homeowners may look to other sources for ready cash – such as retirement accounts. Reports show that in 2010 a total of 9.3 percent of households who maintained retirement accounts paid a penalty to withdraw some $60 billion from those accounts.

There are, of course, legitimate reasons for using the cash equity of a retirement account prior to its maturity. The IRS may allow you to receive a hardship distribution because of an immediate and heavy financial need, which can be declared for medical care; the purchase of a principal residence (excluding mortgage payments); tuition and related educational expenses for the next 12 months of post-secondary education; preventing eviction from or foreclosure on the employee's principal residence; funeral expenses; and repair of the employee's principal residence.

The problem with taking some monies out of a long-term account such as a 401(k) is that its growth potential is reduced.

Is there an alternative? Besides personal loans or borrowing against assets, people can tap insurance money – whatever is borrowed will be subtracted from a death benefit. Also, many people are turning to family members for loans, since mutually agreeable loan terms can be decided, and won't deplete retirement funds.

Or an even simpler idea is to reduce expenditures. Lower bills. Defer student loan payments, if possible. Refinance a mortgage or a credit card rate.

It is clear that in times of dire economic straits workers will take many paths to save their finances, including withdrawing from retirement funds. But with the national economy on the rebound, financial advisers may well want to consider methods to help workers regain their footing, and re-establish or reinvest in their retirement accounts, both for their present and long-term financial health.

Peter Chieco is a senior vice president and financial adviser at Morgan Stanley Wealth Management in Greenwich, Conn. He can be reached at 203-625-4897.

The information contained in this article is not a solicitation to purchase or sell investments. Any information presented is general in nature and not intended to provide individually tailored investment advice. The strategies and/or investments referenced may not be suitable for all investors as the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Investing involves risks and there is always the potential of losing money when you invest. The views expressed herein are those of the author and may not necessarily reflect the views of Morgan Stanley Wealth Management, or its affiliates Morgan Stanley Smith Barney, LLC, Member SIPC.