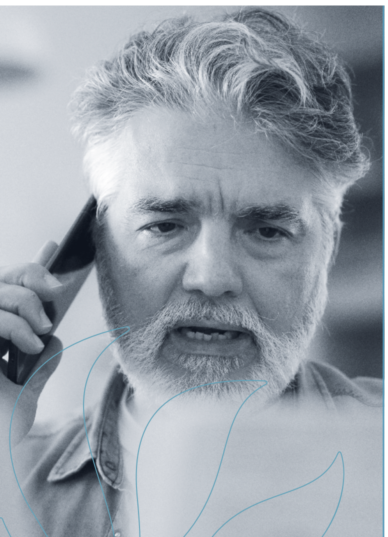
The Cost of Cashing Out



Understanding the Consequences of 401K Early Withdrawals

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YOU HAVE WORKED HARD to build up your 401k, but now you're facing an unexpected expense or a financial hardship and you're tempted to cash out early. Before you decide to withdraw your funds, it's crucial to understand the potential consequences.

A 401k retirement savings plan allows an employee to set aside pre-tax dollars from their paychecks. The money in a 401k grows tax-free until it is withdrawn, usually after retirement. However, if you withdraw money from your 401k, a traditional or a Roth 401k, before you turn 59-and-a-half years old, you incur a 10 percent early withdrawal penalty. That's in addition to the taxes on the withdrawal, which the IRS treats as ordinary income.

TAX IMPLICATIONS

If you're considering cashing out your 401k, it's essential to factor in the tax implications. You'll want to calculate how much you'll owe in taxes on your withdrawal and compare that to the amount of money you need. Remember that if you're under age 59 and a half, you'll also owe a 10 percent early withdrawal penalty. Early withdrawal might also leave you subject to other fees, such as an administrative fee for processing the withdrawal or closing your account.

Some 401k plans also have restrictions that apply to early withdrawals. For example, you could be subject to a vesting schedule based on years of service that determines how much of your employer's contributions to your plan you are entitled to.

Before you cash out your 401k, be sure to read the fine print and understand all the fees and penalties associated with early withdrawals.

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TAX BRACKET IMPLICATIONS

Your tax bracket is determined by your income, and it's essential to understand how that will affect your 401k withdrawal.

Your taxable income includes money you earn from your job, plus other sources of income.

For example, if you're single and your taxable income is $40,000, you're in the 12 percent tax bracket. If you withdraw $10,000 from your 401k, you would potentially owe $1,200 in taxes plus the 10 percent early withdrawal penalty, a total of $2,200. However, your withdrawal has moved you into the 24 percent tax bracket, so you'll owe $2,400 in taxes on your withdrawal plus the 10 percent early withdrawal penalty, a total of $3,400.

Your taxable income includes money you earn from your job plus other sources of income, from rental properties or investments for example. Be sure to factor in all your income when calculating your tax bracket and the taxes you would owe by withdrawing funds from your 401k.

ALTERNATIVES TO CASHING OUT

If you're facing financial hardship and you need to access your funds, there are alternatives to cashing out your 401k. One option, if your plan allows it, is to take out a loan against your 401k. With a 401k loan, you borrow money from your account and pay it back with interest over time. While you'll owe interest on the loan, it may be less expensive than paying taxes and penalties on a withdrawal.

A word of caution about 401k loans: If you leave your employer and are no longer an active participant making contributions, the remaining loan balance is not forgiven. Unless you're able to pay it off in full, or the plan has other post-employment payment options, it is typically considered a taxable distribution. You will receive a 1099 and incur the tax consequences, just as if it were a withdrawal.

EARLY WITHDRAWAL PENALTY EXCEPTIONS

The best way to avoid 401k early withdrawal penalties is to leave your funds in your account until you reach retirement age. However, if you need to access your funds earlier, there are some exceptions to the early withdrawal penalty, although you will still incur the income tax obligation:

- If you become disabled, you can withdraw money from your 401k without penalty.
- You could consider a hardship distribution. Hardship distributions are for an "immediate and heavy financial need" such as major medical expenses, catastrophic damage to your home, or to avoid foreclosure or eviction. You can withdraw money from your account without penalty, but you'll still owe taxes on the withdrawal. However, not all 401k plans offer hardship distributions, so be sure to check with your plan administrator.
- Under an IRS provision known as the Rule of 55, you can withdraw money from your 401k without penalty if you leave your job at age 55 or older.

LONG-TERM CONSEQUENCES

Cashing out your 401k early can have long-term consequences on your retirement savings. When you withdraw money from your account, you're reducing the amount of money that can grow over time in a tax-advantaged way. Additionally, you'll miss out on any potential investment gains you'd earn by keeping your funds in the account.

Furthermore, if you withdraw a significant amount of money, you may have a difficult time catching up on your retirement savings. The longer you wait to start saving again, the more challenging it can be to reach your retirement goals.

IS IT WORTH THE COST TO CASH OUT EARLY?

In most cases, cashing out a 401k early is not worth the cost. Taxes, penalties, and fees could have a long-term negative impact on your retirement savings. Instead, consider alternatives like 401k loans or hardship distributions, or look for other ways to reduce your expenses or increase your income. It's essential to consider all options and make an informed decision.

If you're unsure about the best course of action for your 401k, ask your financial advisor. A financial advisor can help you understand the potential costs and benefits of different options and develop a plan to meet your financial goals.

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