You Have More Access to Your 401(k) Than You Think – and That's Not Always a Good Thing

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When it makes sense to dip into your retirement account — and when it doesn't.

When policymakers consider **leakages from 401(k) plans**, they must balance two conflicting goals: 1) keeping tax favored savings in the plan so that funds are available at retirement; and allowing access to participants who need their money, which can encourage greater participation and larger contributions.

That said, the current setup seems a little crazy. Participants can take their money out in three ways.

- Hardship withdrawals: Participants can withdraw funds for an "immediate and heavy financial need," which includes medical care; postsecondary education; and buying, repairing, or avoiding foreclosure on a house. Hardship withdrawals generally are subject to income tax, a 10-percent penalty tax, and 20-percent withholding for income taxes.

- Cashouts upon job separation: An employee can take a lumpsum distribution, or preserve the balance by leaving it in the prior employer's plan (if the employer permits), rolling over the plan balance into an IRA, or transferring it to the new employer's 401(k). Distributions are subject to the 10-percent penalty tax (if under age 59½) and the 20-percent withholding requirement.

- Loans: About 90 percent of 401(k) participants have access to a loan feature. The Internal Revenue Code limits the borrowing to 50 percent of the account balance, up to $50,000. Loans do not require approval but generally must be paid back within one to five years. If a loan is not repaid due to default or job loss, the remaining balance is treated as a lump-sum distribution and is subject to the penalty and to income taxes.

Let's start with the most favorable assessment. Loans offer the biggest bang for the buck in terms of access to balances. Most borrowers continue to contribute to the plan while they have a loan; and most of the money is repaid. Consequently, estimated leakages from loan defaults are very small.

Hardship withdrawals make sense as a safety valve for families in financial trouble. However, these withdrawals could be limited to serious unpredictable hardships such as disability, high health care costs, and job loss. Predictable needs like housing and higher education could be excluded. With such limitations, the disincentive of a 10-percent tax penalty could be eliminated to avoid punishing those with severe financial problems.

The really annoying and largest source of leakage is people cashing out when they change jobs. It makes no sense at all for changing jobs to act as a trigger for tapping retirement saving. The problem is that it is virtually impossible to move money from one 401(k) plan to another: plans are not required to accept incoming rollovers; they use a variety of forms and procedures; and they face no standards for timeliness and efficiency. Without easy portability, money either becomes stranded in small accounts, moves involuntarily or voluntarily to IRAs, or more frequently is cashed out.

My preference would be to prohibit cashing out at job changes entirely. At the same time, the Department of Labor needs to push plan sponsors to make 401(k) balances truly portable.

Retirement Clearinghouse LLC has established a platform for automatically transferring balances under $5,000 from an old plan to a new plan, but we need a system with standardized forms and procedures for balances of all sizes.

This is not rocket science! We can do it!