401(k) Loan and Distribution Considerations — Which, if any, should you take?

everhart ADVISORS

The Coronavirus Aid, Relief and Economic Security (CARES) Act makes it easier than ever for certain **'qualified individuals'**[1] to tap into their retirement plan accounts prior to retirement age and with fewer tax consequences. In response to the possible need for participants to access cash in this time of economic crisis, the CARES Act permits employers sponsoring a qualified retirement plan, such as a 401(k), to voluntarily and temporarily:

- Increase plan loan limits up to the lesser of $100,000 or 100% of the participant's vested account balance (applies only to loans taken for a period of 180 days starting March 27th, 2020);
- Allow for participants with outstanding plan loans to delay loan repayment(s) due from March 27, 2020 through December 31, 2020 for up to one year;
- Provide access to 'coronavirus-related distributions' up to $100,000 from a retirement plan, with a waiver of the 10% early withdraw penalty tax and ignoring the 20% mandatory withholding.

These new loan and withdrawal provisions allowed by the CARES Act are optional for employers to adopt and there are certainly prudent reasons they may not. You should contact your employer or recordkeeper to confirm if your retirement plan has voluntarily adopted any of the optional provisions permitted under the CARES Act and for help in determining whether you are a 'qualified individual.'

Decision Point: Should you access retirement money just because you can?

Just because these provisions may now be available does not mean you should utilize them. Ideally, your money would stay and grow in your account until you retire—realistically, desperate times call for desperate measures. If your employer has adopted these provisions and you are a 'qualified individual,' we encourage you to take a moment to weigh the pros and cons before tapping into your retirement accounts.

The first question to ask yourself is whether you really ***need*** the money. If you have exhausted all other means to cut back on expenses and increase cash flow (using a budget, cancelling subscriptions, coupons, etc.), then certainly the coronavirus-related loan and distribution options are there for this very reason: to provide financial relief to your current situation.

We suggest taking a loan or distribution only as a last resort—if you do not necessarily need the money from your retirement accounts for living expenses or you haven't exhausted other means to cut expenses or access cash, keeping the money in your retirement account is the best option.

By taking a loan or a distribution from your retirement account you would be selling investments that are likely down in value for the year. Historically, markets have taken about 3.9 years to recover from large drops in the market such as the one we experienced earlier this year.[2] To sell your investments now would mean potentially missing out on the recovery that has historically followed big drops in the market. Once a withdrawal is taken, the loss is locked in and can no longer be recovered.

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[1] – Diagnosed with COVID-19 by a test approved by the Centers for Disease Control and Prevention;
– whose spouse or dependent is diagnosed with COVID-19;
– who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19; or
– other factors as determined by the Treasury Secretary.

[2]https://finance.yahoo.com/news/manage-money-living-m-telling-090052954.html

In fact, if cash flow is not an issue, consider putting more money into your retirement accounts. Dana Anspach, the author of the book, Control your Retirement Destiny, comments:

> "…one of the worst things retirement savers did during the 2008 financial crisis was they stopped contributing to their 401ks or other retirement accounts. Not only should you continue to contribute to your retirement account, but also you should consider increasing your contribution. If you invest more while the market is down, you'll get more bang for your buck, Anspach said. "This is a buying opportunity of a lifetime."[3]

However, we understand that many are not in the same financial position they were in at the start of the year and do not have much of a choice. Therefore, if you have no choice but to pull money from your retirement account, we encourage you to explore and understand the loan and distribution options before acting.

As a reminder, the following provisions are only for those 'qualified individuals' who have met certain coronavirus-related criteria AND whose employer has chosen to adopt these provisions.

The Loan:

Since the date of enactment, March 27th, the limits for coronavirus-related loans have doubled, which means you may be able take up to 100% of your vested account balance or $100,000, whichever is less, until September 23rd, 2020. For 'qualified individuals,' any loan payments due from March 27, 2020 through December 31, 2020 may be postponed up to one year. Although extended by the length of the payment suspension, a coronavirus-related plan loan still has a maximum 5-year repayment term, and you must still pay the loan back with interest (including interest accrued during payment suspension).

Keep in mind, you are borrowing from your future self—any money taken as a loan is no longer invested with compounding interest, possibly missing growth opportunities that could significantly impact your long-term financial goals and retirement planning.

Loan payments are made with after-tax dollars, which ultimately leads to double taxation if the money in your account was contributed with pre-tax dollars. You pay the loan back with after-tax money only to then get taxed on the money again when you withdraw the funds in retirement.

Lastly, if your employment were to be terminated, the balance of the loan will have to be paid back in full, with assets held outside of the retirement plan, by the time taxes are due for that year. If you are unable to pay back the loan in full by this time, the loan generally will be considered a withdrawal on which you must pay income tax and may also incur a 10% penalty if under the age of 55.

The Distribution:

For the full calendar year of 2020, 'coronavirus-related distributions' (CRD) can be up to $100,000 or 100% of your vested account balance, whichever is less. In addition, the 10% penalty for early withdrawals has been waived for coronavirus-related distributions. Please note, this is $100,000 in total, per person, no matter how many retirement accounts you have.

If you qualify and decide to take the distribution, realize any pre-tax dollars will be added to your taxable income and could bump you into a higher tax bracket for the year. While the mandatory 20% tax withholding requirement is waived under the CARES Act, this doesn't mean you won't owe taxes—it is very important to budget appropriately to pay your tax bill in the future.

Perhaps the most significant provision related to the 'coronavirus-related distribution' is the extraordinary flexibility to repay and/or manage the resulting tax liability. You can choose to spread the taxes owed over three years, while even better, the CARES Act gives you up to three years to redeposit the withdrawn money into a retirement account—usually you only have 60 days to do so. You can put the money back into an IRA or 401k within the three-year window and avoid the tax bill altogether.

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[3]https://401kspecialistmag.com/good-reasons-not-to-raid-that-401k/?utm_source=401k&utm_medium=email&utm_campaign=401k_enl_03212020_WEEKEND

Decision Point: So, which one is better for you, the loan or the coronavirus-related distribution (CRD)?

For those that believe they will continue working for their current employer, the plan loan is likely the better option because you will not owe ordinary income tax on the money, you can pay it off over a longer period of time, you're paying yourself the interest, and you eventually get the money back into your retirement account. While participants can avoid taxes on the CRD if the money is put back in the account within three years, history and human behavior tell us many people won't.

For those that are uncertain about their future employment, the distribution is likely the better option because you can delay taxes owed for up to 3 years, avoid the 10% penalty for early withdrawal, and also have the opportunity to replenish the funds within the three year time period.

Remember, if you leave or are terminated by your employer, in most cases, the entire remaining balance of a plan loan will come due by the tax filing for that tax year (and must be paid in full with assets held outside the plan) or otherwise default.

Final Thoughts

The coronavirus-related loan and distribution may be helpful for those who truly need it. If you must dip into your retirement savings, take out only the minimum you need to cover necessities. But for those that qualify and are not in dire need to access their funds, tapping into your retirement account now may be detrimental to the future of your retirement and should be avoided, if possible.

Not only should taking a loan or distribution be a last resort, we encourage you to continue contributing to your 401k, focus on the long term, and stay the course if you can—even if your employer has eliminated its 401k match due to the crisis. Even better, consider increasing your contribution and getting "more bang for your buck."

You should contact your employer or recordkeeper to confirm if your retirement plan has voluntarily adopted any of the optional provisions permitted under the CARES Act, for help in determining whether you are a 'qualified individual,' and to confirm the process for submitting a loan or CRD request specific to your vendor.

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