July 8, 2018

# VERY EXPENSIVE MONEY

There are times when a quick infusion of cash is needed to take care of personal or business obligations or that surprise expense. It is always tempting to use those retirement funds that are just sitting there, sometimes doing nothing (in some cases).

**WHAT YOU NEED TO KNOW:**

If you are under the age of 59 ½, taking a distribution from an IRA, 401k or other retirement account (Early Distribution) can be some of the most expensive money you every used.

Other than for certain specific exceptions, funds you withdraw from a retirement account are going to be subject to not only Federal and state income taxes but also a Federal and state additional taxes on the Early Distribution. Exceptions to the Early Withdrawal or "Penalty" tax are listed on a Reference Table at the end of this newsletter:

There are two levels of cost. The immediate (or at the time you file your tax return) tax cost, and then the opportunity cost of the loss of retirement plan equity and it's earning potential.

Here are some illustrations of these costs.

Individual, filing as Single, No Children, Taxable Income of $45,000 before Early Distribution

| | | |
|---|---|---|
| Federal and State Tax-Without $15,000 Early Distribution | | $ 7,934 |
| Federal and State Tax-With $15,000 Early Distribution | | 14,465 |
| **Additional Tax Cost** | | **$ 6,531** |
| Net Funds (Early Distribution less Tax Cost) | $ 8,469 | |

Married Couple, filing as Joint, Two Children eligible for Child Tax Credit, Taxable income of $80,000 before Early Distribution.

| | | |
|---|---|---|
| Federal and State Tax-Without $15,000 Early Distribution | | $ 8,867 |
| Federal and State Tax-With $15,000 Early Distribution | | 15,242 |
| **Additional Tax Cost** | | **$ 6,375** |
| Net Funds (Early Distribution less Tax Cost) | $ 8,625 | |

Because the early distribution income is added on top of your other income, it can also have the effect of causing you to lose tax credits or deductions as your reach certain income limits. OUCH!!

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While it seems like using funds from retirement may be the quickest and least complex way to get some additional working capital, more pitfalls await. Many of those who choose this route intend at some point to try to "put the money back" into their retirement. But life makes is difficult sometimes to fulfill those good intentions.

Let's look at the consequences of losing the tax deferral on those retirement dollars and their tax deferred earnings:

Assume the Individual in our earlier example is 35 years old and that they intend to retire at age 60. Let's assume that after they used the early distribution taken originally, they were able to save and accumulate an equal amount of net dollars within a year but kept them outside the retirement plan.

Here is what those funds would grow to at age 60 under both scenarios assuming 5% compounding monthly interest. Since the funds outside the plan are earning after tax rate the effective monthly compounding interest rate is only 3.537%

| | **Outside Plan** | **Inside Plan** |
|---|---|---|
| Today | $ 0 | $ 15,000 |
| One year from today | $ 8,469 | 15,750 |
| Twenty Five years from today | $ 19,768 | $ 52,162 |
| DIFFERENCE | | $ 32,394 |

Alternatives to taking an early distribution:

1. See if Retirement Plan or 401(k) allows participant loans. Take a participant loan rather than a distribution.
2. Home Equity Loan (if a homeowner)
3. Refinance Auto
4. Credit Card Advances
5. Personal Consumer Loans-such as offered by companies like OneMain Financial
6. Family

Even though the financing costs can be high on some of these alternatives, since the actual cash you are getting is much smaller than required if an Early Distribution is taken the overall cost to you will be much less.

***REFERENCE TABLE-Exempted from Early Withdrawal Tax***

| | Qualified Plans (401k, Profit Sharing, Etc) | IRA . |
|---|---|---|
| After Participant or IRA Owner reaches Age 59 ½ | YES | YES |
| Rollovers- In Plan Roth rollovers or eligible distributions contributed to another retirement plan or IRA within **60 Days** | YES | YES |
| IRS Levy- Because of an IRS levy of the plan (to collect taxes you owe) | YES | YES |
| Death- After the death of the plan participant or IRA owner. | YES | YES |
| Disability- Total and permanent disability of the plan participant or IRA owner. | YES | YES |
| Equal Payments- If distributions are made as part of a series of substantially equal payments over the participants life expectancy or the life expectancies of the participant and their designated beneficiary. | YES | YES |
| Automatic Enrollment- Permissive withdrawals from a plan with auto enrollment features (where the employee has been automatically enrolled but chooses not to participate) | YES | YES (Simple IRA's & SARSEP's) |
| Military- Certain distributions to qualified military Reservists when called to active duty | YES | YES |
| Medical- The amount of unreimbursed medical expenses (UME) greater than 7.5% of Adj Gross income, or 10% of UME if under 65, for 2019 & later | YES | YES |

***REFERENCE TABLE-Exempted from Early Withdrawal Tax (cont'd)***

| | Qualified Plans (401k, Profit Sharing, Etc) | IRA |
|---|---|---|
| Corrective Distributions- Corrective distributions (and associated earnings) of excess contributions and excess deferrals, If made timely | YES | n/a |
| Domestic Relations- To an alternate payee under a Qualified Domestic Relations Order (In connection with divorce, dissolution or legal separation) | YES | n/a |
| ESOP (Employee Stock Ownership Plan)- Dividend pass through from an ESOP | YES | n/a |
| Separation from service-(leave Job) during or after the year the employee turns 55 (Age 50 for public safety employees of a state, or political subdivision of a state in a governmental DB Plan) | YES | NO |
| First Time Homebuyers- Qualified First Time Homebuyers, up to $10,000 | NO | YES |
| Health Insurance Premiums- Health Insurance Premiums paid while unemployed | NO | YES |
| Returned IRA Contributions- If withdrawn by due date of tax return | n/a | YES |
| Earnings on returned contributions | n/a | NO |