Pomegranate Financial

Refresh & Simplify
Your Financial Life

Newsletter

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Your 401(k) - Withdrawals, Taxes, and More

The 401(k) is an investment account for retirement and provided through your employer. Your traditional contributions give you a tax discount now and delay tax on the growth until you take them out.

What can you invest in a 401(k)?

This will depend on your employer's 401(k) plan. Most plans provide investments in the stock market such as a 'Target Date 20XX.' These investments are a combination of hundreds of stocks and bonds within a fund. Some 401(k) plans (though rare) do allow for alternatives such as cryptocurrency, hedge funds, real estate, gold/silver, etc.

Roth vs. Traditional 401(k)

The Roth contribution is post-tax meaning you make the contribution after you have already paid taxes on the funds. For example, taxes are withheld from your paycheck and then a portion of your paycheck is made towards your Roth 401(k). This does not affect your current taxes.

The Traditional contribution is pre-tax meaning you make the contribution before your taxes are withheld. You taxable income is reduced by the amount you contribute each year.

How much do Traditional contributions save you on taxes?

It depends on your highest tax bracket. If a portion of your income is taxed at 22% then you save 22% on your Traditional contribution. For example, if your income is $125,000 and your standard deduction is $27,700, then your taxable income is $97,300. The 22% bracket starts at $89,451 (in 2023) so then the next $7,850 of your income is taxed at 22% ($97,300 - $89,450). If you contributed $7,850 to your Traditional 401(k) you would save $1,727 in Federal income tax ($7,850 * .22). You would also save on state taxes which would vary based on where you live. For Utah, it would be 4.50% or $353 in this example.

When to contribute to your Roth 401(k) vs your Traditional 401(k):

Since the 401(k) is meant for your retirement you will likely be taking it out in retirement after age 59.5. If you knew your highest marginal tax rate was going to be above 22% in retirement, then a Roth would be more advantageous. If you knew your retirement tax rate would be less than 22%, then a Traditional contribution would be more advantageous now. It actually gets much more complicated than that because your income, tax rates, tax laws, and more can change year to year.

The penalty associated with withdrawing your 401(k) before age 59.5.

If you withdraw from your 401(k) early then you will be penalized 10%. No tax credits or deductions will eliminate that tax penalty. In addition to that penalty you will also face the taxes owed. The amount you withdraw increases your taxable income by that amount. For example, a taxable income of $97,300 and taking out $7,850 from a 401(k) will increase your taxes by 22% or $1,727 plus your state taxes AND the additional penalty tax of $785 for a total of $2,512.

Exceptions to the penalty when withdrawing from your 401(k) before age 59.5.

The IRS does allow some exceptions to the 10% penalty. Here are most of those exceptions:

- Auto Enrollment - if you were auto enrolled in your 401(k) and didn't realize it. Then you have 90 days from your first automatic contribution to take it out without any penalty.
- Disability - you become totally and permanently disabled
- Domestic Relations - a court order relating to a divorce
- Equal Payments - you set up a plan to take out your 401(k) over a series of equal payments over time
- Homebuyers - qualified first-time homebuyers, up to $10,000
- Levy - the IRS puts a levy on your plan (you owe the IRS money and they seize your IRA)
- Medical - amount of unreimbursed medical expenses > 7.5% of AGI
- Medical - the health insurance premium you pay while you are unemployed

As you can see the exceptions are limited.

How do 401(k) loans work? And when might it make sense?

Taking funds out of your 401(k) is an expensive decision. So what about a loan from your 401(k)? Loans can be taken from your 401(k) up to 50% of the balance with a maximum of $50,000 (with some restrictions).

The repayment plan is typically a 5 year loan with interest and payments each month. If you leave your employer or are terminated, then the 401(k) loan has to be repaid typically within 60 days. If you default, then it becomes a taxable distribution and subject to the 10% penalty.

The interest rate on the loan is typically 1% to 2% above Prime rate. The current Prime rate is 8.25% (as of late June 2023) which means you are likely looking at a 10% APR interest rate. While high, the rate is much better than 22% to 34%+ (as it is with a distribution). Yet, this also means that the funds from the loan are not invested. Those funds are then missing out on potential growth. Repayments on the loan are not contributions and therefore not deductible. Yet, they will still be taxed in the future when taken out.

The repayment which includes the interest and principal actually all goes back into your 401(k) account, but on a post-tax basis. Essentially this means the interest rate is like a 0% rate. You are missing out on the investment growth AND the repayment is now a post-tax amount that will be taxed when taken out in the future.

When could it be worth it to withdraw from your 401(k) before 59.5.

There are very rare circumstances where it makes sense to withdraw from your 401(k). Some potential possibilities would be avoiding bankruptcy, the exceptions stated above, or where there is such a need AND no other options. But, there is often another option that is much better to satisfy the need.

Other Options (these vary based on your personal finances):

There are many to evaluate including savings, cash value in your life insurance, personal loan, 0% interest credit card (even with a 3% or 5% balance transfer), HELOC, taxable investment account, principal portion of your Roth IRA or 529 plan, 401(k) loan, and most options where your interest will be less than 20% APR!

Conclusion:

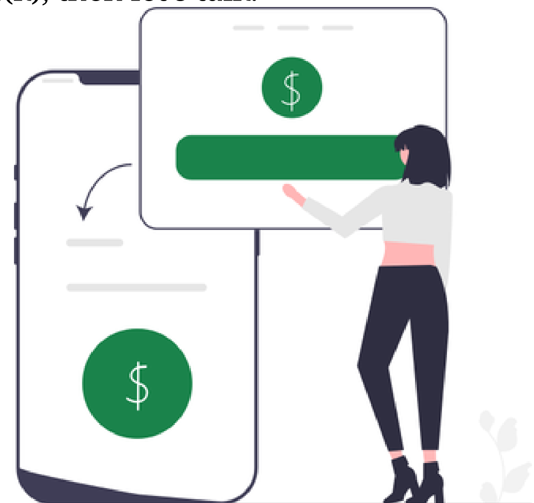
Taking funds out from your 401(k) to pay off other debt, purchase a home (not your 1st), pay taxes, or purchase other goals like a vacation, car, etc. is very expensive. It will likely cost you between 22% upwards to 34% or more depending on your income and tax bracket!

There are often many other much better options to evaluate first as mentioned above.

It may seem like the easier route since it's your own money in the 401(k), but it is definitely of the most expensive ways. Most loans or source of funds charge less than 22% interest!

For example, say you need $20,000 which you have in your 401(k). Typically what happens (and typically should not) is you decide to take out $20,000 from their 401(k), except your institution says that 20% will be withheld for Federal income tax. So instead you take out $25,000. Out of the $25,000, $5,000 is withheld for Federal income tax (maybe some for state tax as well). Nothing else to worry about...until tax time when you find out that you owe $2,500 (10% penalty) + $500+ (22% bracket or higher) totaling $3,000. This is in ADDITION to the already $5,000 you had withheld! And don't forget if you didn't have state taxes already withheld then you'll owe the state taxes as well.

If you have been thinking about taking funds from your 401(k), then let's talk.
I am confident we can strategize together to find an option that costs you less than an early 401(k) withdrawal!



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